S. HRG. 98-61

GLOBAL ECONOMIC OUTLOOK

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
INTERNATIONAL ECONOMIC POLICY

AND THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

JANUARY 10, 19, FEBRUARY 1, AND APRIL 13, 1983—STRESSES AND STRAINS IN THE INTERNATIONAL FINANCIAL SYSTEM (SUBCOMMITTEE ON INTERNATIONAL ECONOMIC POLICY)

FEBRUARY 15 and 23, 1983—STRESSES AND STRAINS IN THE INTERNATIONAL FINANCIAL SYSTEM (COMMITTEE ON FOREIGN RELATIONS)

Printed for the use of the Committee on Foreign Relations

U.S. GOVERNMENT PRINTING OFFICE
16-632 O WASHINGTON : 1983

S381-24

COMMITTEE ON FOREIGN RELATIONS

CHARLES H. PERCY, Illinois, *Chairman*

HOWARD H. BAKER, Jr., Tennessee
JESSE HELMS, North Carolina
RICHARD G. LUGAR, Indiana
CHARLES McC. MATHIAS, Jr., Maryland
NANCY L. KASSEBAUM, Kansas
RUDY BOSCHWITZ, Minnesota
LARRY PRESSLER, South Dakota
FRANK H. MURKOWSKI, Alaska
CLAIBORNE PELL, Rhode Island
JOSEPH R. BIDEN, Jr., Delaware
JOHN GLENN, Ohio
PAUL S. SARBANES, Maryland
EDWARD ZORINSKY, Nebraska
PAUL E. TSONGAS, Massachusetts
ALAN CRANSTON, California
CHRISTOPHER J. DODD, Connecticut

EDWARD G. SANDERS, *Staff Director*
GERYLD B. CHRISTIANSON, *Minority Staff Director*

SUBCOMMITTEE ON INTERNATIONAL ECONOMIC POLICY

CHARLES McC. MATHIAS, Jr., Maryland, *Chairman*

RICHARD G. LUGAR, Indiana
RUDY BOSCHWITZ, Minnesota
FRANK H. MURKOWSKI, Alaska
CHRISTOPHER J. DODD, Connecticut
JOSEPH R. BIDEN, Jr., Delaware
PAUL S. SARBANES, Maryland

LETTER OF TRANSMITTAL

UNITED STATES SENATE,
COMMITTEE ON FOREIGN RELATIONS,
Washington, D.C., April 20, 1983.

Hon. CHARLES H. PERCY,
Chairman, Committee on Foreign Relations,
United States Senate, Washington, D.C.

DEAR MR. CHAIRMAN: We are enclosing a summary of findings from the seven hearings held earlier this year by the Subcommittee on International Economic Policy and the full Foreign Relations Committee on "Stresses and Strains in the International Financial System."

As you know, the Subcommittee held four hearings January 10, 19 and February 1 receiving testimony from a range of experts including former Secretaries of the Treasury, bankers and economists. On February 15 and 23 the full Committee heard from Secretary of State George Shultz and Secretary of the Treasury Donald Regan. A final hearing was held on April 13.

These hearings were held in anticipation of an Administration request for additional resources for the International Monetary Fund. This request was subsequently received and reported favorably out of the Committee on March 16.

We have attached, as appendixes to the hearing transcripts, the memos prepared by staff for each of the hearings together with a Congressional Research Service study entitled "U.S. Policy Options on Polish Sanctions" which includes an analysis of the Polish debt situation.

It is also our intention to include the summary of findings and recommendations from these hearings as part of the hearing record.

We would only note, in closing, that in our judgment this hearing record provides a powerful endorsement of the need for Congressional approval of increased resources for the International Monetary Fund.

Sincerely,

CHARLES McC. MATHIAS, JR.
CHRISTOPHER J. DODD.

Enclosures.

SUMMARY OF FINDINGS

Current global economic situation

In the course of its hearings, the Committee found a broad consensus among its witnesses, that the current world economy is in the deepest economic decline since the Great Depression of the 1930s. Unemployment, and idle plant capacities in the West are at 30-year lows. At the same time developing countries are experiencing the lowest commodity prices and the highest debt burden in the post World War II era. Continued contraction in the world economy may lead to what Felix Rohatyn warned would be "a unilateral repudiation of external debt by a country that is politically radicalized by depression, by IMF imposed austerity or a combination of both."

The origins of the current economic problems

Witnesses noted that the debt crisis that emerged in 1982 had its roots in the rising inflationary pressures in the late 1960's and 1970's, the twin oil shocks of the 1970's, and official policy responses that attempted to mitigate the impacts of these forces on individual domestic economies. The results of these policies were higher inflation, slower economic growth and rising government sector deficits. The deep recession which ensued with the 1979 oil price increase was as much a result of tight monetary policies, especially in the United States, as it was a byproduct of the inflationary cycle generated by the price increase itself. In its wake, this recession has left 32 million workers in the OECD nations unemployed.

The effects in the developing nations have been considerably more severe. In order to maintain their high economic growth rates, the LDCs needed access to huge amounts of capital either through increased aid flows from the West, or through commercial bank lending. Since the real level of concessional aid flows increased marginally, if at all, most of the larger LDC economies turned to the private commercial sector for their capital needs. Between 1973 and 1982 LDC private debt grew from $40 billion to $375 billion. Prior to the 1979 recession, these loans were a profitable business for the commercial banks as continued inflation pushed up export earnings providing the wherewithal for repayment. However, with tighter monetary policies being imposed by major industrial nations after 1979, and with concomitantly higher interest rates and slowing inflation, export earnings began to decline while demand for credit continued. New loans were then needed to refinance old debt. Debt service, expressed as a percentage of exports, has now risen to staggeringly high levels for some debtor-nations (e.g. 129 percent for Mexico, 122 percent for Brazil and 179 percent for Argentina).

Recommendations from hearings

In addition to a unanimous endorsement in favor of U.S. participation in increasing IMF resources, the Committee also noted the following recommendations, which were offered in the course of Committee hearings, to deal with the current economic situation:

(1) Any global economic recovery will be predicated on the size and the rate of recovery in the United States economy. Real growth is linked to significant reductions in the huge Federal budget deficits that have been projected through the late 1980s, particularly in the United States.

(2) There is a need for greater international coordination of policies between governments, multilateral institutions, and private lending institutions in formulating trade, financial, and domestic economic policies.

(3) Greater understanding is needed, particularly in the United States, about the economic linkages which exist among countries. It was noted repeatedly that we now export 10 percent of our GNP (double that of 10 years ago) and that 29 percent of our exports now go to the LDCs.

(4) In addition to expanded IMF resources, there is a need for continued commercial bank lending to many of these economically troubled countries in the near term, as well as increased multilateral and bilateral aid flows.

(5) Huge short term debts of the LDCs may need to be restructured into long term loans at more manageable interest rates. One of the most extreme forms this restructuring might take was a proposal to "write down" commercial bank loans by having some portion of them assumed by one or more mulitlateral agencies in order to meet the need for a long term low interest rescheduling of existing LDC debts.

(6) There may be a need for improved regulations and coordination of the international lending practices of the commercial banks.

(7) Some kind of stabilization of the main trading currencies should be a necessary part of any resolution of the current global economic problems; although there was no specific advocacy of a return to a fixed exchange rate system.

(8) On the subject of trade barriers and other protectionist measures, various proposals were suggested to improve GATT's dispute settlement mechanism, and to expand GATT's framework to include trade measures which have not come under its provisions or regulations. The witnesses were critical of proposals to further restrict world trade.

CONTENTS

Hearings days: Page
- January 10, 1983 1
- January 19, 1983 123
- February 1, 1983 303
- February 15, 1983 369
- February 23, 1983 403
- April 13, 1983 491

Letter of transmittal III

JANUARY 10, 1983

Statement of:
- Blumenthal, Hon. W. Michael, chairman and chief executive officer, Burroughs Corp., former Secretary of the Treasury, Detroit, Mich 25
- Fowler, Hon. Henry H., chairman, Goldman Sachs International Corp., former Secretary of the Treasury, New York, N.Y 3
- Krause, Lawrence B., senior fellow, The Brookings Institution, Washington, D.C 70
- Mellor, John W., director, International Food Policy Research Institute, Washington, D.C 97
- Schultze, Hon. Charles L., visiting professor of research, Stanford University, former Chairman, Council of Economic Advisors, Stanford, Calif 35
- Sewell, John W., president, Overseas Development Council, Washington, D.C 87

Insertions for the record:
- Prepared statement of Henry H. Fowler 9
- Prepared statement of Hon. W. Michael Blumenthal 31
- Prepared statement of Hon. Charles L. Schultze 43
- Prepared statement of Lawrence B. Krause 73
- Prepared statement of John W. Sewell 90
- Prepared statement of John W. Mellor 100

JANUARY 19, 1983

Statement of:
- Cline, William R., senior fellow, Institute for International Economics, Washington, D.C 279
- de Vries, Rimmer, senior vice president and chief international economist, Morgan Guaranty Trust, New York, N.Y 127
- Heimann, Hon. John G., cochairman, Warburg Paribas Becker, Inc., former Comptroller of the Currency, New York, N.Y 172
- Rohatyn, Felix G., senior partner, Lazard Freres & Co., New York N.Y 271
- Solomon, Robert, guest scholar, The Brookings Institution, Washington, D.C 157

Insertions for the record:
- The world's problems are our problems—reprinted from the Washington Post, January 18, 1983 125
- Prepared statement of Rimmer de Vries 132
- Biographical data of Robert Solomon 156
- Prepared statement of Robert Solomon 160
- Prepared statement of Hon. John G. Heimann 176
- Biographical data of Felix G. Rohatyn 271
- Prepared statement of Felix G. Rohatyn 276
- Prepared statement of William R. Cline 284

FEBRUARY 1, 1983

Page
Statement of:
- Bradley, Hon. Bill, a U.S. Senator from New Jersey 304
- Hormats, Hon. Robert D., Goldman Sachs International Corp., former Assistant Secretary of State for Business and Economic Affairs, New York, N.Y 333
- Miller, Hon. G. William, president, G. William Miller & Co., Washington, D.C, former Secretary of the Treasury and former Chairman, Federal Reserve Bank 320
- Ogden, William S., vice chairman and chief financial officer, Chase Manhattan Bank, New York, N.Y 324

Insertions for the record:
- Prepared statement of Hon. Bill Bradley 308
- Prepared statement of Hon. G. William Miller 322
- Biographical data of William S. Ogden 324
- Prepared statement of William S. Ogden 327
- Prepared statement of Hon. Robert D. Hormats 337

FEBRUARY 15, 1983

Statement of Shultz, Hon. George P., Secretary of State 371

Insertions for the record:
- State Department's responses to additional questions submitted by Senator Pressler 400
- State Department's responses to additional questions submitted by Senator Pell 401
- State Department's responses to additional questions submitted for the record 401

FEBRUARY 23, 1983

Statement of Regan, Hon. Donald T., Secretary of the Treasury 404

Insertions for the record:
- Prepared statement of Hon. Donald T. Regan 411
- IMF financing and LDC debt service 475
- Treasury Department's responses to additional questions submitted for the record 481

APRIL 13, 1983

Statement of:
- Hoppe, William L., manager of economic studies, Bethlehem Steel Corporation, on behalf of American Iron & Steel Institute, Bethlehem, Pa 501
- Schechter, Henry B., director, Office of Housing and Monetary Policy, AFL-CIO, Washington, D.C 492

Insertions for the record:
- Prepared statement of Henry B. Schechter 495
- Prepared statement of William L. Hoppe 503
- Steel manufacturing 515

Appendix:
- Memorandums to Members of the Committee on Foreign Relations regarding the hearings on the international financial system 519
- U.S. policy options on Polish sanctions 546

GLOBAL ECONOMIC OUTLOOK

MONDAY, JANUARY 10, 1983

United States Senate,
Subcommittee on International Economic Policy
of the Committee on Foreign Relations,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10 a.m., in room SD-419 (4221 DSOB), Hon. Charles McC. Mathias, Jr. (chairman of the subcommittee) presiding.

Present: Senators Mathias, Lugar, and Pressler.

Also present: Senator William Proxmire.

Senator **Mathias**. The committee will come to order.

This is the first in a series of hearings that the Subcommittee on International Economic Policy will be conducting with respect to stresses and strains in the international financial system.

Today and for the next several weeks, we will solicit the views of experienced and knowledgeable witnesses on the problems that plague the global economy and on the measures that should be taken to address these problems.

I think there can be little doubt that the world economy is in serious trouble. Unemployment in the industrial West moves steadily upward. There are predictions in Europe, for example, that within the next 6 months 1 million additional men and women will become unemployed. The OECD [Organization for Economic Cooperation and Development] estimates that by 1985, 34 million people in the OECD area will be unemployed.

The recession in the West makes life very difficult for struggling developing countries. Commodity prices have plummeted to a 30-year low and, in the meantime, a number of lesser developed countries are laboring under very sizable external debts.

Paul Volcker, the Chairman of the Board of Governors of the Federal Reserve, has advised that what is especially important is that all the participants in the global economy achieve a high degree of common understanding, recognizing the potentialities and the limitations of each for action.

On the basis of that understanding, we can then deal forcefully and effectively with the problems at hand. And we are in effect this morning taking Paul Volcker's advice and trying to achieve, if not a high degree of understanding at least some degree of understanding, of the nature of these problems and what can be done about them.

One thing that I think must be understood is that Americans cannot separate themselves from the difficulties of others. Hundreds of American banks have loans outstanding to financially troubled developing countries. It is not just the big New York City banks, it is not just the Wall Street money men that are involved, it is regional banks; it is small town banks; it is Main Street banks. I am not suggesting that they are in danger of immediately going broke, but I am suggesting that some serious losses could occur which could affect the ability of these banks to provide the credit which an expanding economy must have available.

There is in addition the problem that when some of the countries most heavily involved—like Brazil and Mexico—in an effort to put their own financial house in order, cut back on their imports as a part of a retrenchment process.

In many cases it is our exports that they are cutting back. So, we should be under no illusion that we can divorce ourselves from the economic problems of the rest of the world.

We are, I think, at a critical juncture. The decisions that our Nation takes with respect to a whole range of economic questions in the coming months could have a profound effect on the future economic well-being of the world.

This committee will probably soon receive an administration request for an additional contribution to the IMF [International Monetary Fund]. How the Congress acts on such a request will send a very important signal to the world about our willingness to make a positive contribution to solving the problems facing the world economy.

The hearings that we will hold this month and next month in this committee are intended to provide a framework within which Congress can better assess the economic challenges that face us.

We are particularly fortunate to have with us this morning three old friends—young men but old friends—who have been not only observers of the international economic scene but have been active participants in that scene.

Henry Fowler, chairman of Goldman Sachs International Corp., formerly Secretary of the Treasury; Michael Blumenthal, chairman and chief executive officer of Borroughs Corp. and formerly Secretary of the Treasury; Charles Schultze, at present a visiting professor of research at Stanford University and former Chairman of the Council of Economic Advisers.

Before I call on our witnesses, let me first welcome Senator Proxmire who has had a long and active role to play in economic decisions in this country and who is participating today. We welcome his presence.

Senator PROXMIRE. Thank you very much, Mr. Chairman.

Mr. Chairman, I am very grateful to you for calling these hearings and also for inviting members of the Senate Banking Committee to attend. I intend to be present as much as possible.

I cannot think of any more important international problem—certainly international finance problem—we have facing us than this one. It is complicated and it is going to be extremely difficult to get the Senate of the United States and the House, for that matter, to go along with the proposal to replenish the IMF.

I think the panel that you have selected here is superlative. I cannot think of three wiser men, men who have more competence in this area, to advice us. But there are so many things here that do seem to go counter to at least the superficial interest of our constituents.

In the first place, they argue that if you are going to provide $9 billion of credit anywhere, how about providing it to the homebuilding industry, or the automobile industry, or other borrowers in this country who have to pay such high interest rates—who still, on a historical basis, are paying high interest rates—lend to them instead of to foreign countries.

There is an answer there, but I think it is an answer that has to be made very effectively and forcefully if we are going to get this through.

In the second place, is this really a bank bailout? I think a lot of people feel it is, particularly in the midwestern part of the country where we have very heavy unemployment and a very high suspicion of this kind of activity.

The third point the chairman has touched on already. If there are conditional loans—and they must be conditional, that is one of the fine contributions IMF has made, they have insisted on more orderly performance by the lesser developed countries [LDC's] that are borrowing money—is not one condition that they limit their imports? And if they do limit their imports, will that not directly hurt the jobs in this country?

And then, of course, there is the question as to whether the IMF, with the best of will and the best of intentions, can do anything about a situation which is beyond their control to some extent. Worldwide recession they can do little about, and commodity prices may be so depressed in some cases—if a country, for example, depends very heavily on coffee exports or depends on wheat exports and those prices are very low—it would seem to me there is not much the IMF can do to help.

At any rate, we have many questions and a lot of material that we have to develop if there is going to be any real prospect of getting this kind of proposal adopted by the Congress this year. I think the chairman deserves a lot of credit for calling these hearings.

Senator **Mathias**. Thank you, Senator Proxmire. We fortunately also have a lot of knowledge, experience, and wisdom here. So, let us begin to tap it. Secretary Fowler.

STATEMENT OF HON. HENRY H. FOWLER, CHAIRMAN, GOLDMAN SACHS INTERNATIONAL CORP., FORMER SECRETARY OF THE TREASURY, NEW YORK, N.Y.

Mr. **Fowler**. Thank you, Mr. Chairman, Senator Proxmire, for this opportunity. I have a prepared statement which I will ask to be set forth in full in the record.

Senator **Mathias**. Without objection, the full statement will appear in the record following your oral presentation.

Mr. **Fowler**. The statement provides, first, some general observations and, really, impressions in part I of that statement and then in part II a more specific analysis of the two major problems which really come together to make a single semicrisis, so to speak. And then, in part III some specific recommendations dealing with these two facets of our current outlook.

My limited oral remarks will simply introduce and note a few highlights of that statement.

I think as both of you have indicated, without being alarmist it is fair to state that the United States and the free world economy, of which it is the key component, face the most serious web of interrelated international economic and financial problems since the disastrous early 1930's led to extended worldwide depression and World War II.

By the same token, the United States and the free world are offered an incentive by this current situation and an opportunity to move into a more constructive, creative, and cooperative era similar to that of the late forties and the early fifties.

The international economic and financial problems we confront in the free world today are not only interrelated, they are also recurrent. Consequently, they are not likely to be lastingly relieved by temporary or easy solutions.

The major problems to which these remarks are addressed are two:

First, the basic cause, in my judgment, for the present malaise is the loss of the healthy mix of policies, at home and abroad, conducive to adequate and sustained economic growth with reasonable price stability that characterized the industrialized democracies during the 1950's and, largely, the 1960's.

Chronic inflation, at abnormally high levels for a period unmarred by a major disruptive war—that is 4 or 5 percent and over—fastened onto the industrially developed countries in the 1970's. It erupted into two spasms of galloping double-digit inflation in the mid and late seventies.

These inflationary outbursts led—as night follows the day—to two extended periods of painful recession and "stagflation" of increasing severity and duration in the industrially developed nations constituting the OECD.

In the last few years of the eighties, this economic decline or pause in the developed world has contributed to—although by no means is the sole cause of—the present economic and financial crisis in much of the Third World.

Today, this period of economic decline or deterioration in the free world is now in its third year with no assured end in sight.

Only recently in some of these economies has some promise of partial relief been sighted from the principal cause—high levels of inflation. Closely linked factors, such as high interest rates, in real or nominal terms, fiscal excesses flowing primarily from sizable structural increases in the scale of government civilian spending and taxation still persist in many countries and are being joined by increasing and excessive unemployment, inadequate investment and capital formation, and a trend toward protectionist "beggar thy neighbor" policies.

Now, all of this results in a very deep uncertainty in the private sector in these countries concerning the lasting character and adequacy of the relief needed and the political will to sustain it.

This psychological block concerning a renewal of damaging inflation seems to be holding back the tide of job-creating private investment and private consumer outlays so essential to a healthy recovery that will be maintained and sustained over a substantial period of years.

The second, but closely interrelated major international economic and financial problem, is the excessive dependence on external borrowing through the international private banking system, particularly by some of the more rapid developing and promising Third World countries as well as some of the OCED nations.

The statistical and detailed factual contours of this problem are well known and I have developed them in some greater detail in part II of my statement. So, I will just summarize the problem briefly here.

In the latter half of the 1970's and the early 1980's, a number of these more rapidly developing Third World nations borrowed externally in increasing amounts in the private international capital markets. These borrowings were particularly heavy in the relatively unregulated Eurocurrency and offshore markets, through syndicated bank loans, arranged by the larger banks or bank consortia but including in the syndicates a far larger number of smaller banks in the developed countries.

The borrowers were sovereign states, their governmental or quasi-governmental agencies, as well as private enterprises operating in the borrowing nation.

This process has continued with increasing intensity despite, in the case of a number of heavily borrowing countries, serious unadjusted deficits in their balances of trade and payments and rising debt service burdens constituting an increased percentage of their exports and GNP [gross national product], and mounting quantities of short-term debts with bunched maturities.

The impact in recent years of economic decline and stagnation in their export markets in the developed industrial nations accentuated the plight of these unadjusted borrowers.

During the past year, the situation came to a head. It began to give rise in 1982 to an increased wave of debt rescheduling and potentials for outright defaults even in some of the major developing Third World nations such as Mexico, Brazil, and Argentina. It threatened to put in jeopardy the soundness and proper functioning of the private international banking system.

A threat to this system, now so vital to the international monetary system and related domestic commercial banking facilities, would have dire consequences for the free world economy, developed, developing, and less-developed countries alike.

Accordingly, the International Monetary Fund, treasuries and central banks of the developed industrial nations have become engaged in a giant and complicated operation to work with the authorities of the borrowing nations and the private international banks to work out the debt problem.

As the chairman has mentioned, this involvement of our country, of the Treasury and the Federal Reserve, in turn is going to involve the Congress by reason of the role of the IMF and the need for adequacy of resources for the IMF in dealing with the problem.

Now, this situation, as my written statement develops, calls for a special degree of bipartisanship and effective cooperation between Congress and the executive branch.

I shall omit any review of my specific analysis of these major problems in part II of my statement and use my remaining time for a few suggestions.

Given the outlook for the free world economy, it seems clear that—I think, Mr. Chairman, you alluded to that—the United States, including the executive and legislative branches of the National Government and the private sector, together with similar sectors in the other industrialized nations, should forge a consensus with each other on a program of action addressed to the outside world as well as to the domestic economy to overcome these two major international economic and financial problems just described.

Some of the specific suggestions that should be considered in formulating this program should include the following—now I will address myself just to list a series that are primarily relevant to handling the problem of international debt.

1. Congress should expedite an authorization for the President, acting through the Secretary of the Treasury, to enter into an agreement with the other member nations of the IMF, increasing the quotas available to the IMF for lending by no less than 50 percent.

2. Congress should expedite legislation increasing the unused credit of 5 billion SDR's [special drawing rights] established by the "Group of Ten" major industrialized nations in the so-called general agreements to borrow [GAB]. Such legislation should authorize also the broadening of membership of the GAB and permitting of the use of resources of the GAB by the Fund to members of the Fund other than the nations participating, under prescribed terms and conditions.

3. The United States, acting through the U.S. Governor—that is the Secretary of the Treasury—and its IMF Executive Director should encourage, approve, and facilitate the establishment of a capability in the Fund to borrow in private international capital markets and national markets of member countries, should that prove feasible.

These three actions, outlined above, would be designed to enable the Fund to make its appropriate and expected contribution to the ordering of the international monetary and financial system in the orderly restructuring of the international indebtedness of member countries.

Other elements in a stabilizing and corrective course of action would include the following:

4. For a major group of countries which have relied heavily on private capital markets to the point of financial crisis, substantial recourse to the Fund's resources for official borrowing must be conditioned on an agreement between the Fund and the member on an adjustment program that will, in time, bring the country's balance of payments in line with the ready availability of foreign resources.

5. The continued participation of the private international banking system, alongside the Fund, in providing a volume of new lending as well as rescheduling a principal and interest so as to ease the borrowing nation through the painful process of adjustment by providing funds for some continuing economic development.

6. The development of special procedures, based on recent experience, to coordinate the various parties involved in a more systematic and orderly approach to debt rescheduling and renegotiation of international debts, public and private.

It was inevitable that the initial cases, Mexico and Brazil, should have to be handled on an ad hoc basis. But I think in view of the complexity of the problems ahead of us some agreed specific procedures between the countries and the institutions involved would be reassuring.

7. A study, under the aegis of the Fund's Interim Committee of Governors and the Managing Director, of recent experience with the international debt crisis, to arrive at new procedures and practices for the coordination of the Fund with major central banks, the Bank of International Settlements [BIS] and the private international banks to avoid a recurrence of this current problem with private international debt.

I am including as an exhibit to my statement an excerpt from a thoughtful and constructive analysis of this aspect of the situation contained in an address by President Anthony Solomon, President of the Federal Reserve Bank of New York on October 7, 1982. [See exhibit A.]

8. Governments and central banks of the developed industrial nations whose domestic commercial banks and their external subsidiaries or affiliates play a meaningful role in the private international banking system should take coordinated steps to establish overt and publicly identifiable arrangements to protect systematically the liquidity and the credit of any of these participatory banks in any further lending operations that may be threatened by defaults or postponements in payments by foreign borrowers of their external debts.

As a corollary of this undertaking, it would be appropriate for the governments involved, working with the International Monetary Fund, to indicate the amounts of future private lending to major or financially troubled borrowers necessary or desirable in the interest of developing countries, developed countries, and private banks alike.

9. This is the most important, perhaps, of all of the things we could do:

The putting in place by the major developed nations of fiscal and monetary policies conducive to a resumption of a truly sustainable recovery over the years ahead in a manner consistent with and conducive to reasonable price stability and consequently lower and more stable interest rates.

This brings us to a few concluding observations or recommendations concerning the other major international economic and financial problem affecting the free world, namely, the restoration of a pattern of sustained economic growth with reasonable price stability in the developed nations that by and large characterized the fifties and sixties.

From what has been previously stated—and particularly if you would read in detail part II of my statement—it will be no surprise that I consider the restoration and maintenance of reasonable price stability in the industrially developed nations, especially the major ones, fundamental to any sustained recovery in the free world economy.

Only by curing and avoiding in the future the chronic and excessive inflation that has characterized many of the major nations in most of the 1970's and early 1980's can any pattern of healthy and sustainable economic growth be restored and maintained. Only in that way can we overcome the excessive unemployment, private business weakness and stagnation, inadequate investment, a trend toward protectionism, and other undersirable characteristics afflicting these economies in recent years. This is a long-pull problem, Mr. Chairman, and "quickie" fixes are counterproductive and self defeating.

Global or pervasive inflation in the free world is something of a new problem requiring new policies. I have outlined in my statement some of the characteristics of this new climate that has given rise to, with intensity, this problem of global inflation.

Individual national efforts to halt or hold down inflation or to stimulate economic recovery, though essential to an international solution, are relatively uncoordinated internationally, giving rise to the grave need for a program, international in scope and acceptance, adhered to particularly by the major free, democratic industrialized nations.

Recognizing this elemental truth, the leaders of the major industrialized democracies at the 1982 Versailles Summit Conference agreed to set up a coordinating group on monetary policy, consisting of the Finance Ministers and central bank governors of the five major countries whose currencies are included in the current SDR basket, with the participation of the Managing Director of the IMF.

Against this background I submit, finally, two simple and specific recommendations:

One, the U.S. Government should seek, through the coordinating group referred to above, the formulation of a joint program for presentation at the next economic summit of chiefs of state of the major industrialized nations—late this spring in Washington. That program should be addressed to a concentration of national policies at home and acts of international cooperation abroad designed to restore a pattern of sustainable economic recovery and growth with reasonable price stability.

Two, in any national governmental activity to stimulate economic recovery, the battle against a return to chronic inflation, like charity, should begin at home.

That commitment should be a standard against which budgets, taxing proposals, Government spending, Government borrowing and extension of guarantees, debt management, Government regulation, trade measures, and many related acts, as well as basic Federal Reserve monetary policy, should be carefully measured.

I will not include in this statement any specific bill of particulars reflecting this basic conviction because they are fully reflected in a shortly to be released "Fourth Policy Statement" of the Committee to Fight Inflation. I serve on this committee as a cochairman along with Mr. Herbert Stein, former Chairman of the Council of Economic Advisers, and a bipartisan group of 12 private citizens who have served this Government in the executive branch and the Congress in positions of major responsibility.

I ask that this report, when available—which will be in the next day or two—to be included as an exhibit to my statement. [See exhibit B.]

Thank you, Mr. Chairman.

[Mr. Fowler's prepared statement follows:]

Prepared Statement of Hon. Henry H. Fowler

My name is Henry H. Fowler. I am here at the invitation of the Committee to present some personal views on the current international economic and financial situation, or, as some would put it, crisis, and its implications for U.S. foreign and interrelated domestic policy.

I served as Secretary of the U.S. Treasury from April 1965 until December 1968 and as the Under Secretary from January 1961 until May 1964. From 1969 until December 1980 I was a general partner of the investment banking firm of Goldman, Sachs & Co. and Chairman of Goldman Sachs International Corp., its subsidiary for international operations. Currently, I continue in the latter capacity and as a limited partner of the parent firm.

Because there are some analogies to the present period of challenge, I should also note one other previous official experience. In the early 1950's a formative period of post-World War II reconstruction and development, I served as Director of the Office of Defense Mobilization and Administration of the Defense Production Administration.

Today, as a private citizen, I feel inadequate in offering advice to this body on the subject in question against the backdrop of complex problems presented in the current international setting.

The most useful advice is probably that which is general and impressionistic in nature. Precise and sharp-edged conclusions and recommendations by any individual, however well founded, are not necessarily productive of solutions. This is especially true when the solutions must emerge from the complicated negotiations and compromises that attend either the internal legislative process or international diplomacy.

However, I shall offer some of both—first, some general observations and impressions (part I) and then a more specific analysis (part II) and specific recommendations (part III).

My comments will be confined to the international and financial situation in the Free World economy, omitting somewhat similar problems in the Soviet bloc. Analysis, conclusions and recommendations in that matter involve predominantly political and security considerations of our foreign policy, quite distinctive from our international economic and financial relations with allied and friendly nations loosely constituting the Free World economy.

PART I. SOME GENERAL OBSERVATIONS AND IMPRESSIONS

Without being alarmist, it is fair to state that the United States and the Free World economy, of which it is the key component, face the most serious web of interrelated international economic and financial problems since the disastrous early 1930's led to extended worldwide depression and World War II.

By the same token, the United States and the Free World are offered an incentive and opportunity by this situation to move into a constructive, creative and cooperative era similar to that of the late forties and early fifties.

Then, fortified by a bipartisan consensus, there was forged an outward looking foreign policy. It combined a resistance to and containment of totalitarian aggression and subversion in Greece, Turkey, West Berlin, South Korea, Western Europe, and many other areas by the United States and like-minded peoples of many nations with the development of the Marshall Plan and the maturation of the International Monetary Fund (IMF), the World Bank and GATT. International cooperation for economic development and interdependence of that era provided the foundation for the decades of relative progress and peace that followed.

Now, as then, the United States must supply the foreign policy leadership and domestic strength. If the strands of international cooperation are to be gathered together in mutually supportive arrangements, enabling the Free World to resume a steady climb to ever higher peaks of economic prosperity and development, this nation must play a leading role.

The international economic and financial problems we confront today in the Free World are not only interrelated, they are also recurrent. The present situation did not emerge instantly as a flash of lightning. It is a creeping cancer, not a sudden stroke. These problems have marred the economic and financial landscape during the 1970's with increasing severity. They have climaxed in the present acute form.

Consequently, they are not likely to be lastingly relieved by temporary or easy solutions.

They require a lasting and disciplined regimen, adapted to new events and developments.

And, most important, we must act believing these problems to be curable.

The major problems to which these remarks are addressed are two, although so intertwined and reactive to each other as to constitute one major challenge.

First, the basic cause for the present malaise is the loss of the healthy mix of policies, at home and abroad, conducive to the adequate and sustained economic growth with reasonable price stability that characterized the industrialized democracies during the 1950's and 1960's.

Chronic inflation, at abnormally high levels for a period unmarred by a major disruptive war (4 or 5 percent and over), fastened onto the industrially developed economies in the 1970's. It erupted into two spasms of galloping double-digit inflation in the mid and late seventies.

These inflationary outbursts led, as the night follows the day, to two extended periods of painful recession and "stagflation" of increasing severity and duration in the industrially developed nations constituting the Organization for Economic Cooperation and Development (OECD).

In the last few years of the eighties, this economic decline or pause in the developed world has contributed significantly to, although by no means is the sole cause of, the present economic and financial crisis in much of the Third World.

Today this period of economic decline or deterioration in the Free World is now in its third year with no assured end in sight. Nor is there any firmly established basis for a recovery in the industrially developed countries that promises a pattern of adequate growth with the reasonable price stability that gives it a sustained character.

Only recently and in some of these economies has some promise of partial relief been sighted from the principal cause—high levels of inflation. Closely linked factors, such as high interest rates, in real or nominal terms, fiscal excesses flowing primarily from sizeable structural increases in the scale of government civilian spending and taxation as a percentage of gross national debt, large excesses of increases in wage and labor costs over rates of productivity, and the unreliability of adequate energy at reasonable costs still persist in many countries and are being joined by increasing and excessive unemployment, inadequate investment and capital formation, and a trend toward protectionist "beggar thy neighbor" policies.

All this results in deep uncertainty concerning the lasting character and adequacy of the relief needed and the political will to sustain it.

This psychological bloc concerning a renewal of damaging inflation, plus the fear that the Free World economy might unravel further or be disrupted by the financial consequences of the second, but related problem, seems to be holding back the tide of job-creating private investment and private consumer outlays so essential to a healthy recovery and sustained growth.

The second, but closely interrelated major current international economic and financial problem, vital to the Free World economy, is the excessive dependence on external borrowing through the international private banking system, particularly by some of the more rapidly developing Third World countries as well as some of the OECD nations.

The statistical and detailed factual contours of this problem are relatively well known. (See, for example, Time magazine, international edition, Jan. 10, 1983, special report, pp. 4-11; IMF Staff Report (1982), World Economic Outlook; Morgan Guaranty Trust Company of New York, "World Financial Markets," October 1982; Goldman, Sachs & Co. International Economic Comment, Nov. 3, 1982, "External Debt of Developing Countries and the World Economy" by Lawrence B. Krause, International Economic Consultant.)

Hence, I shall confine my descriptive comments to a brief summary here and a somewhat more specific analysis of its overall origins and nature in Part II.

In the latter half of the 1970's and the early 1980's, a number of the more rapidly developing Third World nations or those with rich resources of oil, gas and metals borrowed externally in rapidly increasing amounts in private international capital markets. These borrowings were particularly heavy in the relatively unregulated Eurocurrency and offshore markets, through syndicated bank loans, arranged by the larger banks or bank consortia but including in the syndicates a far larger number of smaller banks in the developed countries. The borrowers were sovereign states, their governmental or quasi-governmental agencies, as well as private enterprises operating in the borrowing nation. The proceeds were used to pay for increasing imports of both essential and less essential products and services and even internal outlays of various types, including, of course, development activities, and, as debts mounted, sharply rising debt service requirements.

This process has continued with increasing intensity despite, in the case of a number of heavily borrowing countries, serious unadjusted deficits in their balances of trade and payments and rising debt service burdens constituting an increasing percentage of their exports and GNP and mounting quantities of short-term debts with bunched maturities.

The impact of the recent years of economic decline and stagnation in their export markets in the developed industrial nations accentuated the plight of these unadjusted borrowers.

During the past year the situation came to a head. It began to give rise in 1982 to an increased wave of debt rescheduling and potentials for outright defaults even in some of the major developing Third World nations such as Mexico, Brazil, and Argentina. It threatened to put in jeopardy the soundness and proper functioning of the private international banking system.

A threat to this system, now so vital to the international monetary system and related domestic commercial banking facilities, would have dire consequences for the Free World economy, developed, developing and less developed countries alike.

Accordingly, the International Monetary Fund (IMF), treasuries and central banks of the developed industrial nations have become engaged in a giant and complicated operation to work with the authorities of the borrowing nations and the private international banks to work out the debt problem.

To proceed effectively to deal with this problem Congress, Parliaments, and legislative assemblies and, in particular, the Senate Foreign Relations Committee will inevitably be involved in a vital way as the specific recommendations in Part III will underscore.

Let me stress once again that these two major current problems in the Free World economy, which are climaxing after some years of emergence, provide a period of maximum challenge and opportunity, particularly for the relatively stable and powerful industrialized democracies, including, but not solely, the United States.

It is a period of challenge and opportunity for both the governmental and intergovernmental institutions, national legislative assemblies, cabinet departments, ministries and international civil services. It is also a period of challenge and opportunity for the private business units, trade unions and financial entities, both managers and rank and file, whose performance is fundamental to the economic workings of a free and pluralistic society. It is, above all, a period of challenge and opportunity for the chiefs of state and national leaders who must provide and negotiate the solutions and encourage their acceptance by the bodies politic of the democratic societies involved.

It is a period of challenge to work together in an unusual degree of harmony to avert the disasters that loom and arrest the deterioration that has marked the last decade, now rising fulltide in the early eighties.

It is equally an opportunity to improve the structure and functioning of procedures for international cooperation, including existing intergovernmental organizations, and create new ones (but only if clearly necessary) not only to deal with the contemporary problems but to avoid their recurrence in the future.

This challenge and this opportunity in foreign policy and interrelated domestic policy are shared by the U.S. Congress and the Executive; they are common to other friendly governments with which the United States is aligned in intergovernmental organizations and alliances; they are common to private corporate managements, free trade unions, and all business entities alike; they are common even to private financial institutions and their regulators.

Given the consensus, discipline, harmony, political will and creative urge that characterized our government and private sector in the forties and early fifties, we can help mightily to dispel the problems that afflict the international economy and lay the basis for another era of economic progress that characterized the 1950's and 1960's.

Nothing less is likely to avert the stagnation, decline or even collapse of our national economies or system of international cooperation that would be the seed bed for domestic discord and international strife.

But something more is required—the need, indeed the necessity, for both a higher degree of international cooperation and a greater sensitivity to the concerns of other like-minded nations who have regained their former strength or emerged as new powers in the last 30 years. This is an area for which the Congress, in general, and this Committee in particular, and the President have an especial responsibility.

Unlike the late forties when the United States had a unique position of unparalleled strength and influence in international economic and financial affairs, now it must increasingly share responsibility for international cooperation in these spheres with other industrialized societies and groupings of friendly and like-minded nations who have advanced in economic and financial position in recent decades.

In addition, in view of the extent to which international financial, economic and security elements have become key parts to domestic as well as international affairs, the conduct of foreign policy has become vastly more complicated, requiring a greater degree of international cooperation and correlation to domestic policy.

These developments have added greatly to the importance of an effective working relationship in this area between the Congress and the President and his principal cabinet officers.

The United States must deal with other governments as a government. As former Secretary Henry Kissinger once put it:

"To appeal for renewed non-partisan cooperation in foreign policy reflects not a preference but a national necessity. Foreign nations must deal with our government as an entity, not as a complex of divided institutions. They must be able to count on our maintaining both our national will and our specific undertakings." (Speech of Jan. 24, 1975.)

So much for general observations and impressions.

Let us turn to a more specific analysis of the two major international economic and financial problems and some specific suggestions for steps to positive solution.

PART II. A MORE SPECIFIC ANALYSIS

As earlier noted, it is my personal judgment that the basic underlying cause for the present economic and financial sickness attacking the Free World economy, is the emergence and indulgence in the past decade of chronic and, at times, galloping inflation.

This inflation has been largely the result of faulty fiscal and monetary policies of an overstimulating character in many nations, including the developed industrialized democracies, plus two periods of oil price explosions engineered by the OPEC cartel. These two spasms of double digit inflation led inevitably to two recessions or periods of "stagflation" of increasing severity and duration.

The developed industrialized democracies of the Free World seem to have lost the happy combination of reasonable price stability coupled with adequate job creating private investment and economic growth that largely characterized the 1950's and 1960's.

They have tolerated too long the cycles of excessive inflation followed by or conjoined to intolerable recession or stagnation.

This unhappy situation has resulted in:

(a) A chronic addiction to excessive inflation, whether at 4 to 9 percent or in double digit figures.

This condition has been characterized by volatile money supply changes, with oftimes excessive monetary increases; by extended periods of abnormally high interest rates, in real or nominal terms, in both short and long term sectors of financial markets; by severe price explosions in energy prices triggered in the beginning by a feeling of the need to keep up with increasing prices of other products and services and carried to excess by cartelized greed; by increases in wage and labor costs substantially in excess of increases in productivity; by mounting debt in households, businesses and governments increasingly out of line with traditional debt service and income capabilities; by a weakening in the financial structures of many debt ridden or equity poor businesses, financial organizations and farms, and governmental bodies.

(b) Frequent periods of economic decline or stagnation causing persistent increases in ever mounting unemployment levels, now reaching dimensions with potentials for weakening political and social stability and further strains in financial structures already weakened by inflation.

(c) Inadequate levels of private investment in production and service facilities and housing, essential to the job creation and increased productivity and capacity for growth characteristic of market oriented economies of the post war period.

(d) Instability and excessive volatility in key exchange rates, resulting in part from highly variable rates of inflation, interest rates and economic activity and in part from speculative market forces, resulting in substantial overvaluation and undervaluation among the currencies of the major industrial countries with a considerable resulting distortion on the behavior of prices and foreign trade.

(e) Increases of both national governmental expenditures and budget deficits to unprecedented levels in peacetime as a percentage of gross national product.

This appears to be due in part to the cyclical consequences of recession on revenues and recession induced outlays for unemployment and welfare and, in part, structural due to legislatively mandated increases in social security payments and civilian and military public employee pensions and welfare outlays to compensate for inflation and satisfy "rising expectations" for public benefits and services beyond the realities of fiscal feasibility and economic capacity without ever rising levels of increased taxation. The trends of these increasing expenditures and deficits and levels of taxation threaten, unless checked and reversed, to crowd out and discourage the resumption of sustained growth and investment in the private sector, dependent on private savings and incentives.

(f) A rising tide and tendency to resort to various forms of protectionism in policies affecting foreign trade, as the pressures of unemployment and industrial decline in established industries mount, giving rise to import restraint at home and/or subsidization of exports abroad, and as complaints about long standing trade barriers and subsidies become more insistent.

(g) A serious erosion in the levels of confidence in the economic future in the private business and financial sector and among individual consumers, so essential to the private investment and consumption demand on which sustained recovery and job creating growth with reasonable price stability in the private sector ultimately depend on.

Each of these facets of the pervasive malaise affecting the industrially developed nations must be attacked and overcome in the domestic economies and through international collaboration.

The latter is necessary in the interdependence between the interrelated industrialized developed nations and, in turn, their market and resource relationship with the Third World. No nation in this interdependent Free World is an economic island. No nation, particularly a free, democratic industrialized market oriented economy can insulate itself from imported inflation or external recession. All must share in varying measure the prosperity or the adversity.

The second major international and financial problem currently affecting the Free World economy is the financial plight of many Third World nations. This problem focuses particularly on those with little or no oil exports or who have been and are running large balance of payments deficits and have accumulated large external indebtedness relying in large part on the private international banking system.

In 1973 the non-oil-developing countries had a current account deficit of about $12 billion. In one year it jumped to $37 billion and continued to range from $28 billion to $36 billion until 1979. With a second wave of oil price increases in 1979–80 and the economic decline or virtual stagnation in their markets in the developed countries, their current account deficits in the ensuing 3 years (1980–82) totalled $282 billion.

Many of these countries absorbed the balance of payments deficits and economic impact of increased cost of imports of oil and industrial products and other items by borrowings particularly through the private international banking system. Some managed to adjust their trade imbalances largely through expanding exports in the partial recovery in 1976–79. Some did not.

Even some nations with substantial oil resources found their reserves and potential development a basis for new and extensive sources of credit in the private international capital markets. Their borrowings enabled them to accelerate the pace of their outlays for industrial and resource development, expand imports of consumer products, and even finance other internal outlays.

Let us not forget that these borrowings from international capital markets for a time served a beneficent purpose. They enabled some of the more rapidly developing countries to maintain a considerable degree of economic progress in the years immediately following the inflationary surge of 1973–74 and the recession of 1974–75. The counterparts of the deficits during much of the seventies and early eighties were surpluses of the OPEC countries, flowing into the banks operating in the Eurocurrency market and "recycled" as bank loans to the deficit countries.

But the relatively undisciplined borrowings in unregulated credit markets left a basis for potential problems for the borrowing countries and the lending banks.

For the non-oil developing countries, particularly in the last few years of huge balance of payments deficits there was a huge accumulation of debt, burdening the borrowers with an increasing debt service, sometimes way out of ratio to increases in exports. (IMF Staff Report (1982) "World Economic Outlook," appendix B, table 30, p. 170; table 33, p. 173.)

Long-term debt service grew rapidly as the total debt expanded and interest rates rose to high levels in "floating rate" loans normally employed in syndicated bank lending. For the non-oil developing countries it had reached $99 billion by 1981, to which should be added large payments in banking claims of less than 1 year and unreported private loans. As a percent of exports of goods and services, debt service for these countries increased from around 10 percent in 1973 to almost 25 percent in 1981, not counting debt with maturities of less than 1 year.

With the increase of indebtedness, a large proportion of new borrowing has had to be used to service outstanding debt, and hence the need for ever larger borrowing if there are to be any new resources for domestic use.

The concentration of external debt in a relatively few of the Third World nations, especially the rapidly developing ones, makes these aspects of the problem more acute. For example, of the banking claims on the non-oil developing countries at the end of 1981, two-thirds was accounted for by six countries: Mexico, Brazil, Argentina, South Korea, Chile and the Philippines.

Private international credits have been extended in huge amounts to nations where there were no accompanying drawings from the IMF (International Monetary Fund), calling for the attachment of conditions designed to adjust existing imbalances of payments, arrest inflation and avoid related fiscal excesses.

Given the political consequences of rising expectations in some of the more rapidly developing nations, it is not surprising that the international borrowing was, in many cases, relatively undisciplined by financial caution. In all too many cases, restraining views of ministries of finance and heads of central banks were overborne by political considerations or the officials were replaced by those with more flexible views.

The relatively unregulated character of the international lending banking units and affiliates in the Eurocurrency and offshore capital markets has resulted in the absence of public restraint on the lending. This condition was coupled with sharp competition for profit potential from fees in arranging syndicated bank loans and charging interest at floating rates geared to be well in excess of interest paid on deposits or bank borrowings. As a result there could well have been something less than a "hard-eyed" banking discipline on the lending side.

Syndicating the arranged loans to a number of lenders and diversification of risk by international lending to a number of borrowing countries was thought to be an insulation from all but an international financial collapse which the public authorities, national and international, would seek to avoid.

In any event, the situation was ripe for some financial difficulty when the second wave of excessive inflation, followed by new oil price explosions in 1979, brought on a second period of recession or "stagflation" in the developed industrial countries.

For 3 years the relative slack in the industrial countries of the OECD has resulted in a declining volume of imports, including oil and gas. (See IMF Staff Report, World Economic Outlook, table 8, p. 149.)

This factor was reflected in sharply reduced volume of exports from oil exporting developing countries and reduced levels of export increases in non-oil exporting developing nations. (Ibid.) This adversity coupled with a steady 5-year decline in the terms of trade of the non-oil developing countries and the decline in 1982 for the oil exporting developing countries. (Ibid. table 9, p. 150.)

This continuing economic slack in the industrial developed countries is having an especial impact on those rapidly developing nations confronted by long existing or recently emerging unadjusted deficits in their balances of trade and payments.

Notwithstanding, some have continued to pursue the same internal programs on a scale requiring increasing imports of capital for debt servicing, imports of both essential and less essential goods and services, and even internal outlays for other uses.

This has resulted for the non-oil developing countries and some who are oil exporters in a continuing buildup of borrowings and debt, an increasing part in shorter term loans, in the private international capital markets. (See IMF Staff Report, appendix B, table 30, p. 170.)

The debt service requirements (principal and interest) for five major borrowers (Mexico, Brazil, Argentina, Chile and Ecuador) in 1982 significantly exceeded their export earnings from sale of goods and services.

During the past summer, it became apparent that, for a number of them, dependence in 1983 and future years on external borrowing through the international private banking system, without a substantial adjustment program of internal policies, was no longer feasible.

The mounting debt burden, particularly the sharply increasing short term segment, was making debt servicing of principal and interest with additional new external borrowing for "business as usual" unacceptable to financial markets and to many of the private banks engaged in international lending.

Indeed, a wave of debt reschedulings with increasing potential for outright defaults, or debt rescheduling on terms dictated by the borrowers rather than pursuant to mutual agreement between lenders and borrowers became imminent. This involved the soundness and continued necessary functioning of the international private banking system, which, in turn, was integrated with important domestic banking facilities of the developed industrial countries.

This development led to the involvement of the public financial authorities of the major nations (Treasuries and Central Banks) on an ad hoc basis involving, for example, Mexican, Argentine and Brazilian debt.

A handling of this critical situation is such a manner as to avoid a disruption in access to the private international capital markets for the non-oil developing countries as a group and the highly troubled ones in particular seems desirable. This is the case looked at alike from the standpoint of the developing countries, the banks, the developed countries and the international monetary system.

Cutting off access to the private international capital markets for additional borrowings by a number of the rapidly developing Third World countries, particularly some of the larger ones, would confine their external borrowing to the limited resources of the IMF, the World Bank and the regional development banks (The Inter-American Development Bank, the Asian Development Bank and the African Development Bank). This process would overload the facilities of these public institutions on which the large majority of the poorer and less developed countries are largely dependent for external aid and capital and probably abort and distort the promising progress of the more rapidly developing ones.

The end results would be to cut down on the growth of Third World markets for the products and services of the developed nations of the OECD, including prominently the United States, which have come to play an important role in their job creating growth.

Needless to add, cutting off access to private international banks, whether for debt service or more carefully limited amounts of new money would undoubtedly lead to outright defaults by debtor countries and threaten the functioning of the international banking system and the international monetary system of which it is an integral part.

The need for constructive action is underlined by elements in the current outlook.

The outlook is colored darkly by the unexpected continuation of the recession conditions in industrial countries which, as previously stated, undermines the ability of the non-oil developing countries to service their external debts out of exports. It is estimated that the volume of international trade in 1982 is likely to have declined about 5 percent. The recession in industrial countries continues to have a strong impact on world commodity prices. (See Goldman, Sachs & Co. International Economic Comment, Nov. 3, 1982, Lawrence Krause, pp. 4–6.)

The IMF forecast a further $97 billion in current account deficits for the non-oil developing countries which would require about $70 billion of net borrowing, more than half from private sources, with more than an additional $140 billion of debt maturing within the year. A constant stream of refinancing is necessary to keep the system lubricated. (Ibid, p. 7.)

Informed observers have noted that quite a few banks in Japan (under informal guidelines from the Ministry of Finance) and smaller regional banks in the United States have used maturing loans as an opportunity to reduce exposure. Yet interest and maturing debt would absorb all the exports, if not renewed. So other banks or official institutions must pick up the slack from banks pulling out of the market. (Ibid p. 7.)

Accordingly, the outlook for the next 12 months depends on the prospects for world trade and commodity prices, the willingness of commercial banks to lend, and the availability of alternative official financing, notably the IMF and associated central banks and monetary authorities. (Ibid p. 7.)

The one major favorable factor in the outlook for borrowing countries is the decline in interest rates since much of the private bank debt is on a floating rate basis and the decline in rates would constitute substantial savings to the borrowers.

The outlook for most of the industrial economies does not hold promise for a major economic recovery in 1983 and sharply increased imports from the developing countries. Nor is the outlook for commodity prices a promising one.

The pace of continuation of international bank credit to the non-oil developing countries is somewhat of a guessing game, depending on assumptions concerning the willingness of the banks to roll over maturing credits and issue new credit.

The participation of the IMF in lending to problem countries such as Mexico and Argentina should increase their creditworthiness, involving as it does approving their adjustment programs for returning to financial stability and sharing the risk.

Accordingly, an active role for the IMF coupled with a responsible continuation of private bank lending and an undertaking of a sensible adjustment program seem to be the key to keeping the international financial system from contracting unduly in 1983, while hopefully some degree of economic recovery in the Free World emerges.

PART III. SPECIFIC RECOMMENDATIONS

Given the present outlook for the Free World economy, it seems clear that the United States, including the executive and legislative branches of the national government and the private sector, should forge a consensus with each other and like-minded nations on a program of action addressed to the outside world as well as the domestic economy.

That program should be designed, among other things, to overcome the two major international economic and financial problems just described.

Some of the specific suggestions that should be considered in formulating this program should include the following:

A. To handle the problem of international debt

1. Congress should expedite an authorization for the President, acting through the Secretary of the Treasury, to enter into an agreement with the other member countries of the IMF, increasing the quotas available to the Fund for lending by no less than 50 percent.

Legislation of this nature should be introduced and enacted as a matter of urgency as soon as the Governors of the Fund have approved the appropriate resolution for an increase in quotas. Legislative approval in the United States is usually the key to ratification of the agreement by other countries. It would be a strong confidence and leadership factor, contributing to the necessary continuance of private bank lending, if the United States Congress should be the first or among the first to ratify.

2. Congress should expedite legislation increasing the unused credit of 5 billion SDRs established by the Group of Ten major industrialized nations in the so-called General Arrangements to Borrow (GAB), broadening the membership of the GAB, and permitting the use of the resources of the GAB by the Fund to members of the Fund other than the nations participating in the GAB, under prescribed terms and conditions.

3. The United States, acting through the U.S. Governor (the Secretary of the Treasury) and its IMF Executive Director should encourage, approve and facilitate the establishment of a capability in the Fund to borrow in private international capital markets and national markets of member countries, should that prove feasible. The process should be conducted soon and in such amounts as will demonstrate the resource capability of the Fund to perform its lending function, should the funds currently available to it prove inadequate, pending the approval of the quota increase referred to above. Once established borrowing in the private markets can then be used later, if needed, to enable the Fund to conduct its function effectively in the intervening period between the present and the quota increase.

These three actions outlined above would be designed to enable the Fund to make its appropriate and expected contribution to the ordering of the international monetary and financial system in the orderly restructuring of the international indebtedness of member countries.

It is estimated unofficially that, as of the end of November 1982 the usable resources available to the Fund were about 21 billion SDR (about 6 percent more in U.S. dollars). There were also unused credit lines with a group of countries under the Supplementary Financing Facility, with the Saudi Arabian Monetary Agency, and with the Bank of International Settlements and a group of central banks, totalling about 10 billion SDR. There are undrawn commitments totalling SDR 7.9 billion which could increase rapidly under recent and new commitments to other countries. In the past gross new use of resources has been running SDR 8–10 billion per year.

The size of quota increase needed depends on the assumed payments deficits of the non-oil developing countries. It is thought by some that up to $50 billion a year of new money will be needed from the private markets and the Fund.

An increase of 50 percent in Fund quotas would yield about SDR $15 billion in new usable resources. This amount added to already available resources is not large when one takes into account present and potential use, as well as some allowance for potential claims of currently creditor countries.

Other elements in a stabilizing and corrective course of action would include the following:

4. For a major group of countries which have relied heavily on private capital markets to the point of financial crisis, substantial recourse to the Fund's resources for official borrowing must be conditioned on an agreement between the Fund and the member on an adjustment program that will, in time, bring the country's balance of payments in line with the ready availability of foreign resources. The elements of the adjustment process are likely to include monetary restraint, budgetary discipline and smaller deficits, the lessening of rigidities affecting wages and prices, and other conditions tailored to the particular borrower's situation.

5. The continued participation of the private international banking system, alongside the Fund, in providing a volume of new lending as well as rescheduling of principal so as to ease the borrowing nation through the painful process of adjustment by providing funds for some continuing economic development.

6. The development of some special procedures, based on recent experience, to coordinate the various parties involved in a more systematic and orderly approach to debt rescheduling and renegotiation of international debts, public and private. While it was inevitable that the early major cases, such as Mexico and Brazil would be handled on an ad hoc basis, that may be less efficient for the process over the long pull. There were three negotiations of this nature with official lenders in 1980 and eight in 1981 and six negotiations with commercial banks in a 2-year period.

7. A study, under the aegis of the Fund's Interim Committee of Governors and the Managing Director, of recent experience with the international debt crisis, to arrive at new procedures and practices for coordination of the Fund with major central banks, the Bank of International Settlements and private international banks to avoid a recurrence of the current problem with private international debt.

I am including as an exhibit to my statement an excerpt from a thoughtful and constructive analysis of this aspect of the situation contained in an address by President Anthony M. Solomon, President of the Federal Reserve Bank of New York on October 7, 1982 at the Bicentennial Financial Symposium in New York.

Mr. Solomon posed the question as follows:

"To sum up, the origins of today's financial strains are bound up in economic shocks, policy misjudgments, and flaws in the structure of monetary and financial cooperation. As a result, there have been no sustained, systematic efforts at the international level to set in motion compatible adjustment actions by major groups of countries. Thus, we come to what seems to me the harder question: what do we need to do to strengthen the international financial system and lessen the future danger of debt levels and maturity profiles that will prove excessive under changing economic conditions?"

Then he outlined two initiatives which deserve examination along with other suggestions.

8. Governments and central banks of the developed industrial nations whose domestic commercial banks and their external subsidiaries or affiliates play a meaningful role in the private international banking system should take coordinated steps to establish overt and publicly identifiable arrangements to protect systematically the liquidity and credit of any of these participatory banks that may be threatened by defaults or postponements in payments by foreign borrowers of their existing debts.

While each central bank would have responsibility for the banks in their own country and their external affiliates, it should be a part of agreed collective action by the major banking nations that will cover adquately the network of involved institutions and thereby avoid the chain reaction of major bank difficulty.

This action will help to avert any deterioration in the effectiveness of the private international banking system to provide the new money that will be necessary to lend to the Third World to sustain their economies through the adjustment period ahead and restore stability and promise to the historic process of encouraging Third World development through lending from external sources.

As a corollary to this undertaking, it would be appropriate for the governments involved, working with the International Monetary Fund, to indicate the amounts of future private lending to major or financially troubled borrowers necessary or desirable in the general interest of developing countries, developed countries and private banks alike.

This facet of a coordinated current stabilization program will be helpful in connection with the study recommended above concerning ways and means of preventing a recurrence of the present crisis long after it has become a page in history.

9. The putting in place by the major developed nations of fiscal and monetary policies conducive to a resumption of a truly sustainable recovery over the years ahead in a manner consistent with and conducive to reasonable price stability and consequently lower and more stable interest rates.

This action, perhaps, is the most significant contribution these nations can make individually and collectively to the longer term restoration of financial stability in the Third World.

Because of the interaction of both recession and sustained economic recovery between the industrialized and Third World countries in terms of less or more foreign trade and high or low real interest rates, this action is fundamental to a fair and satisfactory solution of the international debt problem for developed and developing countries, borrowers and lenders, and the institutions, public and private involved.

This brings us to a few concluding observations or recommendations concerning the other related major international economic and financial problem affecting the Free World—the restoration of a pattern of sustained economic growth with reasonable price stability in the developed nations that by and large characterized the fifties and sixties.

B. The restoration of healthy sustained non-inflationary growth

From what has been previously stated (see, particularly, Part II), it will be no surprise that I consider the restoration and maintenance of reasonable price stability in the industrially developed nations, especially the major ones, fundamental to any sustained recovery in the Free World economy.

Only by curing and avoiding in the future the chronic and excessive inflation that have characterized many of the major nations in most of the 1970's and the early 1980's can any pattern of healthy and sustainable economic growth be restored and maintained. Only in that way can we overcome the excessive unemployment, private business weakness and stagnation, inadequate investment, a trend toward protectionism and other undesirable characteristics afflicting these economies in recent years. This is a long pull problem and "quickie" fixes are counterproductive and self defeating.

Global or pervasive inflation in the Free World is something of a new problem requiring new policies.

There are some special characteristics of the 1970's which should be noted in charting any strategy for dealing with the international economic and financial problem of combining economic recovery with reasonable price stability.

These characteristics are:

1. The extraordinary growth of Free World Trade and transnational money and capital flows, welcome though it is, nontheless has resulted in linkages between national economies that have converted inflation into an international, as well as a national problem.
2. A widely pervasive revolution of "rising expectations," giving many national economies an inflationary bias, has climaxed with simultaneity in many national economies in the 1970's. In a number of important industrialized nations, this attitude has overborne the fiscal and monetary disciplines particularly essential to the avoidance of damaging inflation in a free democratic society.
3. The 1970's have been characterized by volatile price movements of essential commodities—agricultural, mineral and energy—which originated in part in natural and man-made limitations on increases in supply and malfunctioning markets.
4. The 1970's have also been characterized by the climax of an earlier trend in the sixties to enormous increases in international capital flows, much of it in bank deposits of highly volatile liquid forms, in relatively uncontrolled money and credit markets, such as the Eurodollar market.
5. The 1970's also witnessed an unprecedented and uncontrolled increase in official international liquidity held in central bank reserves, accompanied by the abandonment of fixed par values and the need to keep a disciplined check on inflation and money creation in order to maintain stable exchange rates.

These Characteristics have profound public policy implications for the current outlook.

Individual national efforts to halt or hold down inflation or to stimulate economic recovery, though essential to an international solution, are relatively uncoordinated internationally, giving rise to the grave need for a program, international in scope and acceptance, adhered to particularly by the major free, democratic industrialized nations.

Recognizing this elemental truth, the leaders of the major industrialized democracies at the 1982 Versailles Summit Conference agreed to set up a coordinating group on monetary policy, consisting of the Finance Ministers and Central Bank Governors of the five countries whose currencies are included in the current SDR basket, with the participation of the Managing Director of the International Monetary Fund.

Against this background I submit two simple and specific recommendations:

1. The United States Government should seek, through the coordinating group referred to above, the formulation of a joint program for presentation at the next "economic summit" of chiefs of state of the major industrialized nations (late this spring in Washington). That program should be addressed to a concertation of national policies at home and acts of international cooperation abroad designed to restore a pattern of sustainable economic recovery and growth with Reasonable Price Stability.

2. In any national governmental activity to stimulate economic recovery, the battle against a return to chronic inflation, like charity, should begin at home. Political leaders, of whatever persuasion, whether in the Executive Branch or the Congress or Parliament, in each of the major industrialized nations, share a common responsibility. That responsibility, at home, is to restore and maintain non-inflationary fiscal and monetary disciplines and other non-inflationary measures to a prime place in national economic policy. Reasonable price stability should be viewed, not as a block to, but as a means of assuring sustainable rates of economic growth.

That commitment should be a standard against which budgets, taxing proposals, government spending, government borrowing and extension of guarantees, debt management, government regulation, trade measures, and many related acts, as well as basic Federal Reserve monetary policy, should be carefully measured.

I will not include in this statement any specific bill of particulars reflecting this basic conviction because they are fully reflected in a shortly to be released Fourth Policy Statement of the Committee to Fight Inflation. I serve on this Committee as a Co-Chairman along with Mr. Herbert Stein, former Chairman of the Council of Economic Advisers, and a bipartisan group of 12 private citizens who have served this government in the Executive Branch and the Congress in positions of major responsibility.

I ask that this Report, when available, be included as an exhibit to my statement.

Exhibit A

[EXCERPT]

Remarks by Anthony M. Solomon, President, Federal Reserve Bank of New York

To sum up, the origins of today's financial strains are bound up in economic shocks, policy misjudgments, and flaws in the structure of monetary and financial cooperation. As a result, there have been no sustained, systematic efforts at the international level to set in motion compatible adjustment actions by major groups of countries. Thus, we come to what seems to me the harder question: what do we need to do to strengthen the international financial system and lessen the future danger of debt levels and maturity profiles that will prove excessive under changing economic conditions?

I start with a basic philosophical view: The problems are sufficiently general and the need for solution is sufficiently pressing that there is a substantial advantage in terms of managing interdependence if governments explicitly recognize the de facto limits on their national autonomy. Obviously all governments, whether from the industrial countries or the developing countries, will find this hard to swallow—preserving the appearance of automony is a high priority in virtually all countries. But we all have to recognize limits and to accept external disciplines when there are problems that cannot be as effectively corrected by individual action alone. The logic is to accept those disciplines early when they will have a positive impact and not wait until problems become so severe that they spill heavily onto others and became harder to solve. It is an illusion that full national freedom of action exists in the kind of world we have, and is wiser to be honest about that and let go of the illusion.

I think more realism is needed in assessing the role of the private financial markets as well. Clearly the world economy benefits enormously from the efficiency of those markets and their ability to reconcile competing demands for credit. But retaining public confidence in the markets requires an official, central bank umbrella.

So, a balance must be struck between the needs of the private markets for freedom of action so that the economy can benefit from efficiency and the need of the banking system for underlying support so that confidence is maintained.

Against that background I want to outline my personal thoughts about two initiatives that I feel would help to bring about a better balance in the world economy.

First at a very general level, I would like to see the IMF charged with the responsibility of developing some overall guidelines on what counts as a reasonable pattern of global current account positions and on what counts as an appropriate pattern of financing of imbalances. What I have in mind is drawing on the precedent already established in the IMF of the so-called guidelines for floating which are now embodied in the updated articles of agreement. The spirit of those guidelines is that they set widely accepted (and acceptable) terms of reference for discussion of specific government actions. They are imperfect and probably should be strengthened to reinforce the case for maintaining realistic exchange rates. But for now they are a good prototype of what might be constructed on the issues of current account imbalances and appropriate financing patterns.

The guidelines on current accounts might specify the characteristics of a group of countries that normally would be expected to run structural current account imbalances—that is their current accounts would be in surplus, or in deficit, on average over the course of a world business cycle. The guidelines might also specify the characteristics of a third group which normally would net out surpluses and deficits over reasonably short time periods.

It could be envisaged that each country with a payments imbalance—either surplus or deficit--that was exceptionally large or persistent would be expected to offer a broad plan for reducing that imbalance to a reasonable norm over a period of years. They might also offer an indication of how supluses might be invested and deficits financed in the interim. This would expand by a considerable step what is called IMF surveillance, and it would enable the Fund to exercise its role as a policy critic and force for adjustment symmetrically and comprehensively.

With this framework of a symmetrical effort to reduce exceptional surpluses and deficits the guidelines on financing would focus on that group of countries with structural current account deficits. These guidelines would stipulate that the financing of structural deficits should include both official and private nonconcessional funding as a matter of course. It would mean that the IMF and other multilateral financial institutions would not be treated either as lender of last resort or as solely providers of concessional financing. But they would play a continuing role in financing at least part of those structural deficits.

There is a danger, of course, that the guidelines for financing patterns could turn out to be too general to be of much practical significance. But as an illustration, one could foresee a set of proposed guidelines along the following lines that could have some real content:

(1) Overall debt should not grow more rapidly over the medium to longer run than a country's ability to service that debt—no faster than a reasonable, conservatively estimated, expansion of goods and services exports.

(2) If exports were to grow faster during a cyclical upswing, then reserves should be built up or some debt paid down.

(3) On debt composition, short-term debt (plus longer term debt maturing over any 12-month period) should be kept within fairly narrow bounds, based on anticipated export receipts, import requirements, and international reserves. The actual proportions will differ (perhaps considerably) from country to country. But what is to be avoided—and the guidelines should specify that—is a sudden rapid increase in short-term debt at times when market conditions for long-term borrowings are tight.

(4) The proportion of debt borrowed at floating interest rates should be limited to reduce the risk that debt servicing requirements might escalate just as a country's export prices were falling. In other words, this guideline would seek to limit the vulnerability of debt servicing obligations to sharp changes in commodity prices and relative interest rates.

(5) On the capital account side, a general guideline could be drawn up on the relationship between domestic interest rates and the exchange rate so as to reduce the risk of private capital outflows, which could easily compound external financing problems. This is one area where discussion of exchange rates, current account deficits, and debt positions needs to be integrated.

We could go on. Consideration should also be given to guidelines on government guarantees of private sector external borrowing, possibly on the currency composition of debt and reserves and possibly on the exposure of domestic banks in the Eurocurrency markets. But while the actual scope of the guidelines should remain an open question at this point, it's clear that they can have content, without going into detailed analysis of every possible country situation.

Second, I think we have to go beyond this, however, and to introduce ways of exerting greater discipline on particular countries which may get out of line and require external policy guidance. What I have in mind is for the Executive Board to agree on a set of objective statistical indicators that seem to be characteristic of the early stages of the external financing problems that countries have experienced up to now. It would be sensible for the Board to agree that countries which appear weaker than average on the basis of several of these indicators would voluntarily sit down with the Fund staff for a joint examination of their economic position, as well as of the structure of their external debt. I would anticipate that both industrial and developing countries would be selected for review from time to time, depending on economic performance. Presumably, the views and suggestions of the Fund would not be binding on the country. But failure to sit down, or to make a reasonable effort at follow through, would as part of the Managing Director's general progress report come to the attention of the Board. Thus, in general although not detailed terms, the private markets would become aware of this, and so there could easily be some consequences for private credit availability. That's one incentive, to put it mildly, for participating. In addition it is not beyond the ingenuity of the Fund to provide incentives for cooperation in the voluntary review process.

As an illustration, the incentive could be in the form of a skewing of funds available under the different credit tranches. That could mean more availability under the lower tranches for early adjustment cooperation with a compensating adjustment in the upper tranches where conditionality is more extensive. Earlier adjustment obviously requires less drastic conditionality—in fact, for those countries which implement Fund suggestions in this early review process the likelihood of upper credit tranche drawings is reduced. In the end, the clout of the Fund is a function of the resources it has to lend and the influence its programs have on the willingness of commercial banks to lend. This type of a financial policy review, triggered by some agreed objective indicators in the context of the broad guidelines mentioned earlier, could be a valuable addition to the institution's leverage.

One of the most frequent charges levelled at the IMF is that it simply provides a bail out for the banks. That charge to my mind is unjustified and misguided. It reflects a misunderstanding both of the philosophy of the IMF Articles, and of how the concept actually works in practice.

The IMF is designed to assist its member countries, not the banks, not the creditors, not the trading partners. If a country with a balance of payments problem is prepared to adopt corrective policies under an IMF approved program, policies designed to reduce its payments deficit, the IMF will provide some financing while the corrective policies take effect. But the value of an IMF program is the financial and economic policies it supports in those countries, much more than in the IMF financing that is customarily provided while the adjustment program takes effect.

Thus the purpose of IMF programs is not to pay off old debts but to encourage sound policies. And in practice, IMF programs have worked out that way. When I served at the U.S. Treasury, and questions of bank bail out were raised by our Congress, we undertook a study of past IMF programs that showed two interesting things. First, it showed that IMF programs typically did not fully cover a borrower's prospective deficit, so that additional borrowing from other sources, rather than repayment of debt, was assumed. Second, it showed that a borrowing country's creditworthiness tended to improve with the successful implementation of an IMF program and private lending to such countries generally increased rather than decreased. In fact, the figures showed that when the IMF programs were followed, bank lending to that group of countries increased by four times as much as the amount of IMF financing provided. This hardly looks like a bail out of the banks—quite the contrary. And recent IMF experience shows the same pattern, that private lending is stimulated by an IMF program.

A look at the arithmetic belies the bank bail out thesis. In Mexico an IMF program is under negotiation. If agreement is reached, Mexico can expect to receive in the first year 150 percent of its IMF quota—or $1.3 billion. This would not go far in bailing out Mexico's debts to the banks of more than $60 billion. But the IMF programs associated with the $1.3 billion of IMF financing is expected to be the centerpiece of Mexico's effort to improve its creditworthiness, change the banks' attitudes toward providing additional credit to Mexico, and to find a more lasting solution to Mexico's financial problem.

In a broad philosphical sense, whether a country chooses to follow the IMF approach or not is in my mind far more important than the question of bank bail out. With an IMF program, there is the prospect of the borrowing country restoring its creditworthiness, re-establishing its financial viability, and remaining a healthy component of the market-oriented international trade and financing system. If that happens, of course the banks benefit—so do our traders, consumers, exporters—and if that is what critics call bail out, so be it. Alternatively, if a country chooses to go a different route, it is likely to find itself in a continuing drift, toward restrictions, toward closing itself off from capital flows and liberal trading arrangements. This would be a kind of opting out by that country from the market-oriented trade and financing system, toward a closed and restrictive world, a sense of isolation. That is a dangerous slope which can ultimately result in a fundamental fracture of a country's political and ideological foundations.

To conclude, today's problems in the international financial system, serious as they are, can be managed. And tomorrow's problems can be averted, or at least moderated. What is needed is a comprehensive effort to buttress both the official institutions and the private markets. An impressive increase in the Fund's permanent resources plus action to expedite an emergency reserve in the IMF along the lines suggested for consideration by the U.S. Administration would provide the Fund with resources to meet contingencies in the years ahead. The IMF's authority would be strengthened further if we can agree to a more compelling mechanism for early policy review leading to adjustment actions. These specific initiatives, together with the inevitably greater influence of this cooperative approach, will provide information and a sense of direction to commercial banks in their international lending. The overall result can be to build confidence in both the short- and the long-run and to promote both the stability of the financial system and the economic recovery that we all want.

EXHIBIT B

COMMITTEE TO FIGHT INFLATION—FOURTH POLICY STATEMENT

Henry H. Fowler, co-chairman, former Secretary of the Treasury.

Herbert Stein, co-chairman, former Chairman, Council of Economic Advisers.

W. Michael Blumenthal, former Secretary of the Treasury.

John W. Byrnes, former ranking minority member, House Ways and Means Committee.

Frederick L. Deming, former Under Secretary of the Treasury.

C. Douglas Dillon, former Secretary of the Treasury.

Paul W. McCracken, former Chairman, Council of Economic Advisers.

George H. Mahon, former chairman, House Appropriations Committee.

William McC. Martin, Jr.,[1] former Chairman, Federal Reserve Board.

Wilbur D. Mills, former chairman, House Ways and Means Committee.

William E. Simon, former Secretary of the Treasury.

John J. Williams, former ranking minority member, Senate Finance Committee.

Inflation has abated markedly since early 1980. At the same time the rates of unemployment and business failures have increased to post-war record levels. With the price indexes rising less than half as fast as earlier and with unemployment swelling to 10.8 percent of the labor force, it is not surprising that recession has largely supplanted inflation as the economic problem of most immediate concern to the public.

We must recognize, however, that the battle against inflation is far from won.

Inflation also slowed dramatically as a consequence of the 1974-75 recession, but later it accelerated to a new peak and it may well do so again. Even if inflation does not accelerate, the current rate is rapid enough to do enormous further damage to our economy and our society.

Our government should not abandon the fight against inflation now, because of the recession. To do so would mean that the nation had paid heavily in lost output, lost employment, and widespread deprivation for the second time in a decade without winning the only reward—a stable price level—that could justify so great a cost.

The Committee to Fight Inflation, a bipartisan group of citizens who have had major governmental responsibilities in the economic and financial area, has issued three policy statements since June 1980. At the outset of this new statement we note our deep concern about the many forces that are now pressing government policy in mistaken directions.

We are disturbed by the prospect of huge budgetary deficits for the indefinite future. We are disturbed by the apparent inability of our policy makers to come to grips with the fundamental problems of the social security system. We are worried that Congress will enact so-called "jobs" bills whose stimulative effects will be felt mainly after the recession is over, when they will feed inflation rather than ameliorate recession. We are worried about the possibility that Federal Reserve policy will swing toward economic stimulus, perhaps in response to a Congressional mandate to seek lower interest rates. And we are distressed by the apparent receptivity of the Congress to legislative proposals to restrict competition at home and from abroad—proposals that would serve special interests at the expense of the national interest in economic growth and price stability.

---

[1] Did not participate in the preparation of policy statement—was out of the country.

These forces that disturb us should also disturb every American who believes that the nation's goal should be a steadily growing, noninflationary economy. In the sections below we briefly describe the kinds of monetary, fiscal, and trade policies that are required for continuing progress toward that goal.

MONETARY POLICY

The government's main weapon in the fight against inflation has been the monetary policy pursued by the Federal Reserve. Because the rate of growth of money has been reduced on balance since late 1979, the growth rate of dollar GNP (total spending for the purchase of goods and services) has slowed. Because the rate of increase in wages and prices moderated only a little at first, the induced weakness in dollar demand has kept output and employment from rising and has increased unemployment.

Over the past year, however, the increases in labor costs and prices have slowed considerably—although not enough as yet to permit employment to rise. If this process is allowed to continue, the rates of increase in wages and prices will fall enough to permit a lasting recovery of output and employment in a noninflationary environment.

The great risk at present is that monetary restraint will be relaxed to an undesirable degree. We are particularly concerned about the implications of various bills now pending in Congress that would encourage or require the Federal Reserve to aim at reducing and stabilizing interest rates. The pursuit of such interest rate objectives under mandatory direction from sources outside the Federal Reserve is likely to be inflationary. Also, because it would create a resurgence of inflationary expectations in financial markets that would put upward pressure on interest rates, it is certain to be self-defeating.

FISCAL POLICY

The Federal budget deficit for fiscal 1983 is now estimated at about $190 billion, or more than 5 percent of GNP. If there were no change in current spending programs or tax laws, the deficit would equal 4 or 5 percent of GNP through 1988, and it would remain extraordinarily large for the indefinite future, even after substantial economic recovery.

Large deficits are a normal consequence of recessions, which hold down tax receipts and increase unemployment benefit payments and other outlays. Insofar as deficits are induced by recession, they are not necessarily inflationary. There is, however, no precedent in our history for a stream of enormous deficits long after the end of a recession. The prospect of continuing deficits of the order of 4 or 5 percent of GNP is particularly disturbing because such deficits would absorb the great bulk of private saving, which typically runs between 6 and 8 percent of GNP. With so little saving remaining for use by the private sector, real interest rates would stay abnormally high and the investment needed for growth in production and productivity, and for jobs in the private sector, would be retarded indefinitely.

Large deficits in nonrecession years would also have important short- and long-run consequences for inflation. In the short run, their inflationary effects could, in principle, be offset by greater monetary restraint, but that would complicate the problems of the Federal Reserve. Their longer-run inflationary impact would arise out of the frustrations of a citizenry with a tradition of rapidly rising living standards that finds itself condemned to a stagnant or slow-growth world. Under such circumstances, there inevitably would be rising pressures for larger slices of the inadequate pie—in such forms as demands for bigger increases in money wages, greater protection against imports, and expanded restraints on domestic competition—all of which would contribute to inflation.

Clearly, we must foster a resumption of substantial and sustained economic growth, and for this purpose we must sharply reduce the size of prospective Federal deficits. We recommend that, beginning with the budget for fiscal 1984, the deficit as a percent of GNP should be scaled down progressively and significantly as the economy moves towards high employment and price level stability. Rather than a constitutional amendment, we recommend enactment in this session of Congress of a law that places a steadily declining limit on deficits for the next five fiscal years. The law should permit deficits in excess of the specified limit only when authorized by legislation approved by three-fifths of each House of Congress and signed by the President.

The needed reductions in the deficit will require extensive and significant action on both the expenditure and tax sides of the budget. That action should be taken in the current session of Congress.

Any significant expenditure savings will have to come from the areas of Federal pension programs, including social security; Medicare; and/or defense. Together with interest charges, these categories will account for almost three-fourths of gross Federal outlays by 1985, and programs in the remaining one-fourth have already been subjected to substantial cuts.

Social security and related programs

However difficult politically, it will obviously be necessary to slow the growth of outlays for social security and Medicare, as well as those for civil service and military retirement and for other programs that confer benefits on the middle- and upper-income classes. We recommend progressive cutbacks from currently projected outlays over fiscal years 1984–1988 by some combination of the following measures:

1. Limiting the size of cost-of-living adjustments in social security and other Federal retirement benefits.
2. Extending the coverage of social security to Federal civilian employees.
3. Subjecting to personal income taxes social security benefits in excess of the beneficiary's previously taxed contribution, as is now done with private pensions.
4. Modifying social security benefit formulas to strengthen incentives for people to defer retirement. At present the incentives are perverse; for example, the benefits for people retiring between ages 62 and 65 are actuarily equivalent to those for people retiring at age 65, whereas benefits for those postponing retirement until after 65 are below the equivalent level. (Changes in these provisions should be implemented over an extended period, in order to avoid imposing on large numbers of people a sudden need to make substantial changes in their plans for retirement.) Also, for people who want to continue working after beginning to receive benefits, the so-called retirement test imposes a heavy effective tax on earnings above a relatively low level, discouraging their participation in the labor force. The retirement test should be abolished at the same time that benefits are subjected to income taxes.

As to financing the social security program, we would not favor drawing on general revenues to make up any shortfalls; social security benefits should be funded wholly out of social security taxes.

In the national debate that has been precipitated by the financial problems of social security, the fundamental issue is the choice that must be made between slowing the rise in benefit payments to retirees or increasing the volume of tax receipts. This issue is being debated on various bases, including those of inter-generational equity and longer-run economic growth, and the ultimate decision may well involve changes in both benefits and taxes from those provided by current law. We wish, however, to stress another major factor bearing on this choice: Any increase in social security taxes raises business labor costs, and thereby contributes directly to the inflation that our nation is now struggling to eliminate.

Defense outlays

The size of the defense budget has come under increasing scrutiny. In our view, defense should not be judged as a budget issue. The economy of the United States is so large and strong that expenditures far greater than proposed can be handled if they are truly necessary. We are not competent to judge the substantive merits of defense issues, although we are impressed by the wide differences of view among competent judges.

We recommend that the Congress, with the assistance of the Administration and the advice of other qualified people, undertake a fundamental reappraisal of the defense program. Such a review may result in identifying currently planned expenditures that could be progressively eliminated or scaled back over fiscal years 1984–88 without damage to the national security.

Other taxes

In order to avoid weakening incentives to work, save, and invest, we would not favor reversing the changes enacted in 1981 in corporation depreciation allowances or the reductions made then in individual income tax rates and in estate and gift taxes. We would, however, urge consideration of certain tax measures to become effective at times consistent with the proposed targets for reductions in the deficit. These measures include temporary new taxes on energy consumption, temporary increases in excise taxes on alcohol and tobacco, and the imposition of additional user fees for commercially valuable government services. If more revenue is needed, consideration might also be given to a broad-based consumption tax.

BARRIERS TO COMPETITION

As noted earlier, monetary restraint acts by slowing the growth in total spending. To the extent that wages and prices continue to advance, the spending slowdown means cutbacks in output and increases in unemployment.

The fight against inflation is proving costly in lost output and employment because it is necessary to overcome the considerable momentum built up by the wage-price spiral over the 1970's. Among the reasons that wages and prices have been resistant to the induced weakness in demand are (1) the widespread doubts that progress against inflation will continue and will prove durable, and (2) the weakness of competition in many markets. The two great solvents of wage and price resistance to monetary restraint are credibility of the anti-inflation effort and market competition; any government measures that increase either will make it possible to overcome inflation sooner and at less cost.

Unhappily, the trend appears to be toward government actions that weaken competition, in the process casting doubt on the government's determination to fight inflation. The strong effort of recent years to scale back anticompetitive domestic regulations appears to have stalled. Congress has been disturbingly receptive to bills that would extend new protections against domestic competition, including measures to relieve doctors and other professionals from the surveillance of the antitrust diversion of the FTC and to give beer distributors and office equipment retailers immunity, like that granted earlier to soft-drink distributors, from antitrust scrutiny of exclusive territorial arrangements. And, most ominously, pressures are mounting rapidly to provide new protections against imports through domestic content legislation and other devices.

Anticompetive measures of these kinds are deplorable under any circumstances, because they are an inefficient means of conferring benefits on particular groups and because the claims of those groups to special benefits are often dubious. But their extension at a time when the nation is engaged in a costly struggle to overcome inflation is nothing short of tragic. Protectionist measures are particularly tragic because they provide no benefits at all; any jobs saved in industries competing with imports are at the expense of jobs lost in export industries.

Fundamentally, inflation will slow only to the extent that people have incentives to moderate their wage and price demands. Because anticompetitive measures weaken such incentives they undercut the struggle against inflation and magnify its costs.

Senator **Mathias**. I would be very happy to have that report and look forward to receiving it.

If it is agreeable to the members—and I welcome Senator Lugar and Senator Pressler—we will ask Secretary Blumenthal to make his statement and Chairman Schultze, and then we can engage in a general conversation which is perhaps the most illuminating way to proceed.

Secretary Blumenthal.

STATEMENT OF HON. W. MICHAEL BLUMENTHAL, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, BURROUGHS CORP., FORMER SECRETARY OF THE TREASURY, DETROIT, MICH.

Mr. **Blumenthal**. Thank you, Mr. Chairman, distinguished members of the committee. I too wish to express my appreciation for this opportunity to appear before you, and to speak to a vitally important subject that concerns all of us at the moment.

I appreciate that opportunity, particularly since you have arranged that I can do so in such excellent company, with Secretary Fowler and Mr. Schultze. I suspect you will find that what I have to say, and perhaps also what Mr. Schultze has to say, will show a very large area of agreement with Mr. Fowler as to both the analysis of the present situation and as to what should be done about it.

I may say at the outset that, having listened very carefully to Secretary Fowler's excellent statement, there is virtually nothing in what he has said that I would disagree with or that—on the contrary I would not heartily endorse.

I have a prepared statement, Mr. Chairman, which, with your permission, I will submit for the record. I will not read it here.

Senator MATHIAS. It will be included in the record.

Mr. BLUMENTHAL. You have of course in your opening remarks, Mr. Chairman, adequately commented on the fact that we do face a somber international economic outlook. I agree with that.

I would say that in the three decades of my professional experience in international business, with two detours to work on similar problems in the Federal Government, I do not recall any period as somber as the present one.

One might add to your list of statistics to illustrate that point. For example, we have a situation in the developing countries now where for the first time population growth exceeds the growth in GNP, with all of the attendant economic and political problems that this entails for these countries and for the entire free world.

Obviously, the very large burden of international debt which for the developing countries and the Communist countries together, amounts to something approaching three-quarters of a trillion dollars, and which for just three major Latin American countries—Brazil, Mexico, and Argentina—amounts to in excess of $200 billion, is a further indication of the seriousness of our problems.

The reasons for this situation are also, I think, reasonably well known. Clearly, the two oil crises in the early and late seventies and the reaction on the part of the world to these crises is a factor. The resulting high level of inflation and the efforts to bring inflation under control with monetary and fiscal policies that had to be very restrictive are a major factor.

But I would want to go a step farther because I think a reading of the record indicates that even prior to these oil crises, beginning in the late sixties in this country, and elsewhere as well, the quality of economic management by the major OECD countries has been less than brilliant.

I think all of us have found it easier to spend than to tax in providing the benefit programs our people wanted. There has perhaps been an excessive desire for real income increases even when the productivity of the economies involved did not warrant that—when the pie was not growing fast enough—and that in itself, even without the major shocks of these two oil crises, tended to exacerbate the problem of inflation and to build problems into the budgets of the various countries, problems which we are facing dramatically in this country at the present time.

The most recent period in the United States, I think, is also characterized by—with the benefit of 20-20 hindsight at least—errors in the mix of monetary and fiscal policy.

Clearly, in the last 2 or 3 years we have relied too much on a very tight monetary policy in the face of an overly liberal fiscal policy. That, in turn, resulted in stratospherically high interest rates which have caused us and our trading partners—given the fact that the U.S. economy is so important in the world—a great deal of difficulty.

This also had other very negative impacts for the United States, causing the dollar to appreciate excessively in relation to the currencies of other countries. Because of high interest rates money was flowing into the United States excessively. The resulting strong dollar is now giving us major difficulties on the trade side.

I believe that the trade problem is already baked in for this and next year. Experience shows that even with a decline in the value of the dollar it will be some time—I would say something like 18 months or so—before the current adverse trend in our balance of trade can be reversed.

In the third quarter of 1982, we were running a trade deficit, I believe, at the rate of something like $13 billion, which implies an annual rate of over $50 billion in 1982. Most of the projections for 1983 would indicate that deficit rising to something like $75 or $80 billion at least.

If we remember that the total we invested and lent abroad since 1960 was in excess of $200 billion, about $220 billion, then I think this trade deficit of $50 billion in 1982 and perhaps $80 billion in 1983 takes on a very special significance and indicates a very difficult situation.

These adverse balances reflect a significant decline in our ability to export while the dollar was overvalued. The chemical industry since the fall of 1981 is down by 17 percent in its exports; manufactured goods by about the same amount; food products by 30 percent, Senator Proxmire—of some interest to certain States in the Middle West. Clearly, this situation requires our urgent attention.

Let me now turn to what might be done. I think three general principles, that have been certainly implied by Secretary Fowler's comments, need to be remembered.

In the first place, though the situation is serious, it is manageable. There is no need for panic. There is no need to run for cover. On the contrary, that would be the wrong approach. We need to be realistic but there is no reason in the world why, working together, adopting appropriate policies in the United States and working with our OECD and developing country trading partners, this situation cannot be handled.

Second, there is no way for the United States or for any other country to go it alone. That would be a self-defeating approach.

In this interrelated world we are all tied in too much one with the other, and the only way in which we will be able to handle this situation is by recognizing that in each country's individual self-interest, cooperation and coordination of policies along the lines that Secretary Fowler has indicated is required.

Third and very importantly, no group of countries working together can handle this matter in the absence of strong, sustained, and intelligent support for the international institutions: The International Monetary Fund, the World Bank, the regional banks, the OECD, the GATT, and similar organizations. We should do this in our own self-interest and so should other countries.

So, as you review the possible steps that might be taken, I would hope that you would begin your deliberations with these principles very much as a foundation for your decisions.

I think at this point I might very briefly comment on a couple of points Senator Proxmire raised in his opening statement.

Bringing the international situation under control, it seems to me, is very much in the U.S. interest—I would even say in the "selfish" U.S. interest—and a few simple numbers, Senator, I think indicate that.

Twenty percent of our industrial production is exported today. Thus we cannot hope to prosper if the present economic difficulties in the rest of the world are not resolved.

One in six workers in manufacturing owes his job to exports.

One-third of U.S. corporate profits is derived from foreign activities.

Two out of five farming acres in the United States are dedicated to foreign markets.

My own company, a large multinational corporation, the Buroughs Corporation, is a very good example and there are hundreds of others that would show a similar picture. Roughly half of our total activity is tied into exports and foreign investments—very heavily to exports.

Clearly, we cannot prosper and we have been held back in our progress by the general problems of the international situation.

The United States, as the single largest and most important economy in the world, has a major responsibility not only in our own interest, but also because without our doing the right things and following the right policies, there is in my view very little chance that the rest of the world can get back on a proper, noninflationary growth track.

What are the specific steps, then, that we would have to take? Well, I would like to suggest that I could not agree more with the suggestion that I believe was subsumed under Secretary Fowler's point No. 9. That is that we, along with other countries, must follow the right mix of fiscal and monetary policy.

In the case of the United States, that means that we must get our own economic house in order. We are a key actor and a leader in the world. If we want to use our influence constructively in the economic and political arena throughout the world, then we must take on the responsibility for making sure that our own economy is in good, sound shape and is strong.

We must face our problems from a global perspective, considering not only what makes sense within the United States but also what the impact is on other countries.

In the recent past, our own record of economic management has not been terribly good. We have allowed sectors and certain geographic regions to decline. We have emphasized consumption too much over investment. We have had no forward projections to guide our policies. It is difficult, really, to identify any particular economic philosophy that we have applied consistently in the application of our monetary and fiscal policies.

Above all, we have to reestablish control over the Federal budget. I know that this is something that the Congress and the executive branch will be struggling with in coming months, but it is clear that it is the first and single most important key to turning this global economic situation around.

It is going to be a delicate task because obviously our economy at the moment is so weak that measures to reestablish balance in the budget have to be managed in such a way that the major impact of cutbacks or possible tax increases occurs not in 1983 but down the road in 1984 or 1985. If they were to be applied immediately it would further weaken the already unsatisfactory state of the economy and further increase the unacceptably high level of unemployment that pertains at the present time.

I would like in this regard, Mr. Chairman, to call your attention and the attention of the other members of the committee to what has become known as the bipartisan appeal to the President and to the Congress—sponsored by former Secretary of Commerce, Peter Peterson, and five other former Secretaries of the Treasury, including Secretary Fowler and myself. It is an appeal about which you will be hearing, I suspect, a great deal in the coming weeks and which has already been endorsed by a very large number of businessmen, academics, and others in all walks of life.

Senator MATHIAS. Coming events have cast their shadow before them.

Mr. BLUMENTHAL. Right.

Well, I think that the ideas contained in these proposals to help resolve the budget crisis will hopefully provide some good material for your consideration.

Our appeal in fact suggests, starting with the base-line numbers that the Congressional Budget Office put together for 1981, that one has to find something like $180 billion by 1985 in order to close this budget gap.

We have focused on three particular areas, $60 billion by 1985 in entitlements and nondefense spending; $25 billion in defense spending which would still allow us a growth of 7 percent in real terms which we consider to be certainly adequate for the appropriate defense of our country, and another $60 billion in various possible revenue-raising and loophole-closing measures.

These three parts of the program, together with the related savings in interest costs, would give us the kind of gap closing that is required to get the budget back under control.

The next step is clearly that the other OECD countries must also do their share. And while all of them must participate, Germany, the United Kingdom, and Japan are particularly important. Together with the United States those four countries account for about two-thirds of the total GNP of the OECD area.

Unlike the United States which has to tighten up on the fiscal side in order to allow additional prudent relief on the monetary side so as to get our long-term interest rates down—which I believe is very important in order to bring forth the necessary investment for a sustained growth in this country—the other three countries probably are now in a position and should be encouraged to prudently loosen up on the fiscal side.

It should be a little easier for them to do so since the inflationary pressures have abated in the world and the dollar is no longer strengthening, is has gradually weakened somewhat in recent weeks.

Third, and that is a point on which Secretary Fowler has commented in detail—I will associate myself with his remarks and not go into it further in any depth—we have to keep up the financing for the developing countries. Full support for a substantial increase in IMF quotas is clearly desirable. The various steps that Secretary Fowler has outlined have my full support.

That is not a bailout for the banks by any means. Not a single dollar in IMF resources would be used to repay the debt to the commerical banks. On the contrary. It has to be seen as a catalyst which makes it possibie for the commercial banks not only to maintain their lending but, when necessary, to further increase their lending along the lines that Secretary Fowler has laid out in his statement.

It also allows us—and that is in our own interest—to keep up our exports. Today we export more to the non-oil-developing countries than we do to Western Europe.

So, again, it is very much in the national interest of the United States to collaborate in supporting this kind of program of increase in the quotas of the IMF and in providing additional resources and additional flexibility to the IMF because that has a very beneficial trade impact on our own export industry.

Incidentally, I also think that there is every reason to give similar strong support to the development lending activities of the World Bank. In the present situation nothing would be more beneficial for speeding the process of worldwide recovery than if the World Bank were in a position to increase its development lending by a significant amount in coming years.

Finally, then, of course we must do everything possible to resist the temptation which is always greatest during a period of economic difficulty—such as the present—to resort to a policy of protectionism.

Everything that I have said, of course, implies that I consider that to be a very injurious and self-defeating policy and it is clearly one that we must resist very strongly.

The analogy that I think President Kennedy many years ago first used by talking about "The rising tide which lifts all the boats when strong trade flows" still applies. The opposite, of course, is true also.

Our goal has to be to induce other nations to be equally intelligent and open in this regard. We cannot do so with threats. We have to do so on the basis of realism, protecting our interest but through negotiation, through long, painful and difficult negotiation.

That has been true for many decades, since the end of the war. That will continue to be true but I know of no single instance where resort to protectionism has really benefited this country. It tends to penalize our consumers and it tends to subsidize the inefficient industries in this country and that, I think, is not a principle that this country stands for, or is in accord with.

So, Mr. Chairman, I end where I began. The problem is manageable. It is a difficult one, it requires collaboration with other countries, and strong support of the international institutions.

It clearly requires additional resources for the IMF and the World Bank and it requires, above all, the intelligent leadership of the United States—first in getting our own economic house in order and then in working constructively with other nations toward a common goal.

Thank you.

[Mr. Blumenthal's prepared statement follows:]

PREPARED STATEMENT OF HON. W. MICHAEL BLUMENTHAL

I appreciate the opportunity to appear before your Committee in order to present testimony on "The Global Economic Outlook."

Mr. Chairman, the current world economic situation is worrisome and precarious. Few people would disagree that we face more problems and greater risks than at any time since the end of World War II. Indeed, looking back on my own professional career over the last three decades as an international businessman with two tours of duty working on economic policy matters in the Federal Government, I cannot recall any comparable period as troubled and fraught with concerns as the present.

The reasons for this admittedly somber statement are by now well enough known to obviate the need for a detailed recounting here. A summary of the facts speaks for itself:

1. The OECD countries are in the midst of the longest and deepest collective recession of the post-war period and no clear end is currently in sight.

Unemployment for OECD member countries stands at 32 million and is generally expected to rise by another 2 million in 1983.

Real GNP for the area as a whole dropped in 1982. Capacity utilization rates, bankruptcies and related indexes mirror this economic malaise to varying degrees in all of the countries.

Moreover, though inflation has decreased substantially in the United States and to varying degrees elsewhere, real long-term interest rates remain historically too high to facilitate a sustained recovery.

2. The unsatisfactory state of the industrialized economies is matched by even more serious economic problems in the developing world.

Raw material and food prices—still the major source of export earnings for many—have dropped by 30 percent and more since mid-1980.

Recession-induced low demand for imports by the industrial world has substantially lessened the total export revenue of many LDC's. Accordingly, in 1981, for the first time in a long while, LDC economies grew less rapidly then did their populations. Some critically important nations such as South Korea and Brazil, have experienced sharp declines in GNP. The prospects for 1983 are that many more countries may face a similar situation.

3. Not surprisingly, such key indicators of world economic health as trade, investment, and financial flows mirror this dismal picture. World trade is declining for the first time since World War II. Protectionism is on the rise everywhere. Exchange rate misalignments complicate international economic relationships, and the major international institutions are facing increasing strains and pressures.

Most important, of course, the seemingly awesome debt burden of the developing and Communist world is straining the stability of the entire international financial and banking system.

Mr. Chairman, the international debt problem has been sufficiently in the news lately to spare me—and you—the need for a detailed description of what is at stake. While it is as easy as it is dangerous to overdramatize the problem, there is, however, no doubt that it presents us with a serious and difficult challenge.

The total debt of the developing and Communist world is in the range of three-quarters of a trillion dollars. Three major Latin American nations—Mexico, Brazil and Argentina—face debts totaling in excess of $200 billion, along with annual debt service costs of some $25 billion.

Clearly these are staggering amounts, involving major and unprecedented problems of liquidity, though not of solvency, for these countries—a distinction which it is vitally important to keep in mind.

How did we get to the present state of affairs, Mr. Chairman? The answer to this question will no doubt be hotly debated for a long time to come and provide grist for the mills of academic economists for many years. Even at this early stage, however, it would appear that the principal causes are reasonably clear.

In the first place, the two successive oil crises in 1973 and 1978-79, have much to do with the present situation. In the industrial world they produced increasingly high levels of inflation which undermined economic stability and growth. In the United States this eventually led to the predominant use of monetary policy and elsewhere to a somewhat different mix of fiscal and monetary measures to stop and reverse the inflationary spiral. Tighter money with interest rates of over 20 percent did break the back of inflation. But it also sent the United States and the OECD countries into the currently deep recession trough from which we have yet to emerge.

Stratospheric interest rates in the United States also led to a major inflow of funds into the United States, thus causing the recent sustained rise and eventual overvaluation of the dollar. The overvalued dollar in turn did much to disrupt trade flows and is now confronting us with the prospect of an unprecedented 1983 deficit on trade account of as much as $70 billion. A trade deficit of this magnitude has, of course, a major negative impact on employment and is likely to reduce our GNP growth by at least 1½-2 percentage points in the coming year.

In the developing world, the two oil crises and the reaction to them were equally injurious. Non-oil producing LDC's borrowed heavily from private Western banks to finance energy imports and to sustain ongoing development efforts—the famous recycling of the OPEC surplus. This strategy worked fine for a while, but high interest rates and the deep recession in the industrial world (and paradoxically in the case of Mexico, the reverse shock of recently declining world oil prices) have now caused the liquidity crunch which threatens the stability of the entire system.

But there is yet a second reason for the present state of affairs. None of the developed countries, including the United States managed their domestic economic policies sufficiently well in the latter 1960's and early 1970's, well before our energy problems emerged. All of us failed to address the hard choices between what we wanted and what we could afford. Unrealistic real income aspirations were never adequately confronted. In most countries, it was a lot easier to spend than to tax.

In my judgment, it is this historical inadequacy of economic policy making in an interdependent world, coupled and greatly exacerbated by the pressures of the two oil crises, that set in train the inflationary process which eventually threatened to get out of control. I believe, Mr. Chairman, there are important lessons to be learned here for the future.

WHAT IS TO BE DONE?

We face the task of restoring the economic health of our own economy while contributing to a world economic recovery in general. In this regard, three fundamental points should be borne in mind:

First, although the risks are considerable, the present problems can be overcome. The current liquidity problems of the LDC's can be solved, and general economic growth and stability in the United States and the rest of the world can be restored. In other words, current global economic problems are manageable. There is no need for panic or for despair.

Second, no one country, including the United States, can do the job alone. In fact, it is highly unlikely that we could on our own achieve anything approaching a sustained economic recovery in the United States without a concurrent improvement in the world economy as a whole. Others, equally, cannot hope to turn the corner without renewed economic growth in the United States.

Third, it follows that appropriate policy formulation in our own country—as well as elsewhere—must be based on a recognition of this interdependence among the industrial nations and between the developed and the developing world. All countries must collaborate bilaterally and through support of the appropriate multilateral institutions, if any one is to prosper. No single nation can hope to go it alone or achieve its own recovery at the expense of any other.

The importance and implications of this interdependence in the modern world cannot be understated, Mr. Chairman. One of my former associates in the Treasury, Fred Bergsten, who is now the Director of the Institute for International Economics, dealt with this point extensively and very persusasively in a speech last fall before the National Press Club. I strongly commend his statement to your attention.

As he points out, there is ample historical evidence that no one country can any longer expect to expand successfully in a stagnant world. The United States' experience in 1977-78, the more recent experience of the French, the Japanese and such LDC's as Korea, Brazil and Mexico are cases in point.

A related point is perhaps less well understood. Not only are other countries heavily impacted by a recession in the United States, but we in turn now depend more than ever on a world recovery as well.

Over 20 percent of United States industrial output is exported. One in every six U.S. workers in manufacturing is dependent on exports. Two-fifths of our farmland produces for foreign markets. One-third of all U.S. corporate profits are derived from international activities and the share of our trade in our GNP has more than doubled over the past decade. The countries of Latin America, including those confronted by serious liquidity problems, are also those in which U.S. industry has important stakes, both as export markets and by virtue of large and important local investments.

In this context, Mr. Bergsten has pointed out that from 1978–80, 60 percent of total U.S. economic growth can be attributed to a sharp improvement in our external balance. On the other hand, a reversal of this situation in 1981 and 1982 with an overvalued dollar leading to a deterioration in our real external balance, was the main cause pushing our economy into a recession.

The point, then, is clear. Our economic programs in the United States must take into account the global perspective. As we restore our own economic health we, as the major Western economic and political power, must exert leadership to collaborate internationally in helping the world as a whole out of the present crisis, and we must seek to do so by promoting maximum cooperation and coordination amongst the major countries involved. We must do so in our own economic and political interest because we cannot hope to prosper alone and because peace and stability cannot flourish where economic stress prevails.

Mr. Chairman, allow me now to conclude by outlining the specific measures which U.S. policy should encompass in an effort to restore global economic well-being.

First and foremost, Mr. Chairman, we must put our own economic house in order. The task will not be easy. It will require courage and some sacrifice, but it is an essential step and the key to all else.

In the recent past, U.S. fiscal policy has been too liberal. The tax reductions enacted in 1981 partially offset by the legislation of August 1982, have contributed to creating major revenue losses for the Treasury. The resulting imbalance between a liberal fiscal policy and a very tight monetary policy designed to reduce inflation was one of the major factors responsible for the current sharp recession.

What is now required urgently is to re-establish control over the budget in the medium term and to put budget on a multi-year path toward balance. The prospect of continuing annual budget deficits in the range of $100–200 billion or more for an indefinite period is simply intolerable. Unless this problem is addressed, it would, in my opinion, preclude any Federal Reserve flexibility for a gradual further liberalization of monetary policy and a sustainable further decline in long-term interest rates. Without such a decline, Mr. Chairman, the necessary increase in investment spending required to ensure a sustained growth of the U.S. economy will simply not be forthcoming.

Re-establishing control over the budget, given the present weak economy, will be a delicate task. The required revenue raising measures and spending cuts should not be made effective immediately, least we run the risk of further delaying and weakening the recovery which may presently be getting underway.

The focus has to be on fiscal year 1985. Action must be taken now to put us on the right path, so that there can be a reasonable prospect that a substantial reduction in the currently projected deficit is achieved by then.

As you may recall, I recently co-sponsored with former Secretary of Commerce, Peter Peterson, and four other former Secretaries of the Treasury, a bipartisan initiative suggesting a particular course of action. I commend our appeal to your attention, Mr. Chairman. You will, in any case, be hearing a great deal about it in the coming weeks.

Our proposals to resolve the current budget crisis, which are finding a very broad base of support throughout the country, suggests a three-pronged approach. First, a fiscal year 1985 reduction target of $60 billion over the August 1981 CBO baseline case for spending on entitlements and other essentially nonneeds related nondefense programs.

Second, a fiscal year 1985 reduction target from the baseline of $25 billion in defense spending. This would still permit a 7 percent real rate of growth in defense expenditures over this period.

Third, a fiscal year 1985 program target of $60 billion in additional revenues, through one of a number of possible loophole closing and revenue raising measures.

Together with the related savings of interest costs of some $30–35 billion, the total budget savings of $175–200 billion by 1985 over the baseline would resolve the current budget crisis in a realistic and fair manner. Moving out of the current recession, such a program would do much to restore confidence and lead us back to the path of sustainable growth.

Next, we must encourage other major industrial nations to adopt the appropriate policy measures needed to put them also on a renewed, upward growth path. Countries like Germany, Japan and the United Kingdom are particularly important since, together with us, they account for more than two-thirds of the GNP of the entire OECD area.

As the OECD has stated in its recently published Economic Outlook of December 1982, "the increase in actual (or ex post) budget deficits can be wholly attributed to cyclical influences on government revenues and expenditures, against which discretionary fiscal restriction is, by intention, attempting to act as a partial break." In present conditions, these countries should let up on the brake and begin to press gently on the accelerator.

Tax cuts would be the quickest way to accomplish this. Meanwhile, as U.S. interest rates have come down and as the dollar has begun to weaken, there is less need for restrictive monetary policy in these countries.

The United States role in this effort should be one of encouraging these countries to take the required steps and of actively collaborating within the OECD to implement the kind of differentiated yet balanced and coordinated expansion program suggested above.

A third critically important requirement for us is to ensure that the developing countries receive the needed financing in the period immediately ahead. Much of this has to come from the commercial banks and we should do everything possible to ensure that the world banking system not pull back from this task. To do so would be highly self-defeating. The resources are available and governments must provide the necessary encouragement and support.

Continued commercial bank landing will be greatly facilitated by the IMF's role as a catalyst. To do so, it will need an enlargement of its resources. The increase in IMF quotas that will be presented to the Congress later this year is a regular 5-year event. It has particular importance now because of the crucial role the Fund has taken on in the debt problem that I have discussed above. The notion that an increase in IMF quotas will be used to "bail out" the banks seems to me to entirely mistaken.

Quite the contrary is true. Because of its clout, the Fund has been able to cajole the banks into increasing their loans to developing countries. Not one cent of IMF loans is being used to repay bank debt. Furthermore, U.S. approval of a substantial increase in IMF resources is in no way an act of altruism. We can already observe a decrease in U.S. exports to developing countries as they struggle to contain their balance-of-payments deficits. Without the sort of assitance the Fund can render, American exports to these countries could fall a lot further. It is worth remembering that we export more to non-oil developing countries than to Western Europe.

Most attention has understandably been focused on those few developing countries with heavy debts to commercial banks. A handful of countries account for most of such debts. But there are scores of other developing countries that are also feeling the effects of the recession in the industrial world. These countries' ability to import depends, apart from their own export receipts, on official assistance from governments and from the World Bank and the other multilateral development banks. These institutions also need financial support from the United States in our own interest.

And finally, of course, we must do everything possible to prevent a return to protectionism and to encourage other countries to do likewise. We must do so in our own interest, for a reduction in trade flows would harm us as much as our trade partners.

It is understandable that in periods of economic difficulty the temptation to resort to self-defeating protectionist measures becomes particularly great. But it gains us nothing. The Administration's defense of liberal trade principles is absolutely correct and deserves strong support.

Mr. Chairman, I end where I began. We live in an interrelated world and together we face a set of complex and difficult economic problems. The global economic landscape is not an untroubled one, but if we move forward in putting our own house in order and work collaboratively with others strenthening the necessary international institutions and adopt enlightened financial and trade policies, there is no reason to believe that our present problems cannot be overcome.

Senator MATHIAS. Chairman Schultze.

STATEMENT OF HON. CHARLES L. SCHULTZE, VISITING PROFESSOR OF RESEARCH, STANFORD UNIVERSITY, FORMER CHAIRMAN, COUNCIL OF ECONOMIC ADVISORS, STANFORD, CALIF.

Mr. SCHULTZE. Thank you, Mr. Chairman. I will read selected parts of my testimony but would ask that all of it be included in the record.

Senator MATHIAS. Without objection, the full statement will be included in the record.

Mr. SCHULTZE. Mr. Chairman, members of the committee, you have asked me to address the topic, "The World Economic Outlook."

As you know, Mr. Chairman—indeed as you indicated in your opening statement—most economic forecasts for the world economy can generally be described not so much as "grim" but as "dreary." Some world economic recovery is expected by most observers, but not sufficient over the next year, or 1½ years, or 2 years, to ease significantly the huge burden of unemployment in the industrial countries or to eliminate the necessity for some painful adjustments in the developing countries.

I see no reason to quarrel with the main thrust of the latest OECD forecast for its own member countries over the next 18 months. That forecast sees a very feeble recovery in industrial countries and about 1½ percent growth in GNP in 1983, rising only a little, 2¾ percent in the first half of 1984.

This is going to be insufficient to keep unemployment in countries, outside Japan, from rising to some 32 million people or almost 11 percent of the labor force, by the second half of 1983 and continuing at that level into 1984.

Economic circumstances for developing countries are also expected to be very difficult over this period as they may be forced—indeed probably will be forced—to reduce their imports in the light of slow export growth, low prices for those exports, burgeoning debt service requirements, and a reduced flow of new private credits from the advanced countries.

Rather than offer a critique of these short-run forecasts, I would like to identify and briefly discuss three economic developments—one each in the United States, Europe, and the developing countries—whose outcomes will importantly influence the evaluation of the world economy between now and the middle of the decade:

Let me just summarize those three points and then discuss each of them briefly.

One, all of the industrial countries are suffering and will continue to suffer the costs and the pain of wringing out a stubborn, embedded inflation. In the United States, the pursuit of monetary policies that are too tight and budgetary policies that are too loose has made, and without a change will continue to make, the costs of this disinflation larger than they have to be.

Even with a policy correction, however, the pace of economic recovery over the next 2 to 3 years will have to be relatively modest, compared to earlier postwar recoveries, in the interest of making further progress against inflation.

Two, in most countries of Europe and in Japan, but not to a major extent in the United States, the inflation of the past 15 years has been accompanied by an increase in wages, relative to prices, well beyond what was warranted by productivity growth.

The result has been a major squeeze of business profits that a mere recovery in business sales will not cure. The standard tools of monetary and fiscal policy may not be able to deal with that problem. So, Europe and Japan may face an additional obstacle to sustained recovery that we do not have in the United States.

Three, among the developing countries, as both of the previous witnesses have laid out so clearly, the combination of steeply rising debt service requirements and a sharp fall in export revenues, occasioned by the world recession, has led to two kinds of problems:

First, a large number of developing countries face an increased need for credit just at the time when their private credit worthiness is deteriorating. Without the maintenance of a substantial new flow of net new credit, these countries will be forced to undergo a far more drastic set of growth-reducing adjustments than would otherwise be called for.

Second, in a very few countries—which nevertheless account for an important share of commercial debt—timely debt repayment has become actually or potentially impossible, raising the specter of financial crisis and imperatively calling for debt restructuring measures that are difficult to negotiate and which, without great care, can build in bad precedents for the future.

Let me comment briefly on each of these problems, starting with the United States.

It was imperative, Mr. Chairman, to halt and then reverse the new surge of inflation that occurred in 1979 and 1980. A major dose of monetary restraint was needed and was applied, beginning in October 1979. And because inflation yields only reluctantly to restraint, output and employment had to suffer.

No matter who was President and no matter how adroitly economic policies had been fashioned, the control of inflation in the past 3 years would undoubtedly have brought on a recession.

But in my judgment, monetary restraint was overdone, especially in 1981 and the first half of 1982. Monetary policy attempted too much too quickly; the necessary slowdown in the growth of the money supply took place far too abruptly. Too much weight was given the argument that inflationary expectations and then inflation itself would quickly evaporate once the Federal Reserve gained credibility in the firmness of its anti-inflationary resolve, and that a sharp reduction in money supply growth would shortly have a large impact on inflation and a small impact on output and employment.

Too little weight was given to the lesson of history, namely that inflation yields only slowly and stubbornly to the tightening of monetary policy. So, as a consequence, the inevitable pain and costs of disinflation were made unnecessarily severe.

More to the point there is a danger, I think, that without a change in the Federal Reserve's earlier attitudes about the stringency of monetary policy, the economic recovery that looks as if it is about to begin will be unnecessarily feeble and halting. This fear stems from two causes: First, that the underlying rate of inflation will continue to yield only slowly and stubbornly and, second, that after the current period of temporary ease the Federal Reserve might revert to a policy of excessive monetary stringency which does not fully recognize the stubbornness of inflation.

On the surface, inflation has been brought down dramatically. The inflation rate in the CPI [Consumer Price Index] fell from a peak of some 13.5 percent in 1979 to about 5.5 percent over the last 6 months. But these numbers, including as they do the effect of volatile and temporary fluctuations in food and energy prices, sharply overstate the magnitude of both the peak and the subsequent decline in the Nation's underlying inflation rate. A better rough measure, which abstracts from these temporary fluctuations, is the Department of Commerce's price index for consumer goods excluding the volatile items of food and energy.

In that measure, the underlying rate of inflation reached a peak of some 9¾ percent in 1980 and fell to a 6½-percent average rate in the second and third quarters of 1982, which is the last available data I have. And even some of that decline reflected the temporary and unlikely-to-be-repeated effects of a large dollar appreciation which lowered the price of imports and of import-competing goods.

On a conservative basis, therefore, the underlying rate of inflation, in my judgment, is still above 6 percent, probably. Even with further progress against inflation, it is unlikely to average less than 5½ percent a year over the next several years.

I should put in a footnote: If something really dramatic should happen to OPEC and the price of oil should really crumble, you would have to redo that part of the forecast. But barring that, I think it is a reasonable expectation.

As you know, the Federal Reserve in recent months has temporarily abandoned its earlier announced targets for the growth of the money supply—M1 in particular. The Federal Reserve is unlikely—again for technical reasons—to go back to targeting the M1 monetary aggregate as the chief instrument of monetary policy.

But if the public pronouncements of Board members are to be taken at face value, the Federal Reserve may revert—not right away but once recovery is well underway—to a monetary policy about as restrictive, whatever its technical details, as the policy that was in effect until recently.

It is my judgment that such a monetary policy cannot finance both a reasonably paced economic recovery and the stubborn residual inflation that is likely to continue. What would give way in this collision is not principally inflation but the pace of the recovery. Interest rates would remain high and could, after a time, even rise. Output and employment would grow very feebly. Unemployment would fall only a little.

An overly tight monetary policy has been and—without major changes—will continue to be accompanied by an overly loose budgetary policy. Secretaries Fowler and Blumenthal—and particularly Secretary Blumenthal—have spent some time on that.

The huge budget deficits that threaten to continue growing throughout the recovery will indeed provide some economic stimulus, principally in the consumer goods and defense industries.

But at the same time, the higher interest rates, occasioned as the burgeoning deficits collide with tight money, will retard recovery in the already depressed interest-sensitive industries such as autos, housing, and investment goods. Moreover, current expectations that the problem will grow worse over the years ahead helps prop up today's long-term interest rates. And finally, quite apart from current problems, huge long-term budget deficits tend to give us an economy structurally biased against productivity-improving private investment.

Two changes in economic policy are thus necessary. Outyear budget deficits ought to be cut substantially but, taken by itself, that is not enough. Monetary policy must also be changed. It should be designed over the next several years to accommodate a sustained, moderate recovery at gradually declining inflation rate.

Even with the best economic policies, however, the United States cannot afford, and is unlikely to achieve, an economic recovery as vigorous as those which typified earlier recoveries of the postwar period. As I pointed out earlier, the underlying rate of inflation remains high and it is essential that we get it down further. This requires caution. We cannot afford to go too fast so as to risk a reacceleration of inflation.

Typically, in the first 2 years of previous postwar recovery, economic growth averaged 5 to 6 percent a year. This time we would not want to aim for more than 4½ to 5 percent—and I said aim, not necessarily forecast that we will get it. And so, although we start with a largest slack and the highest unemployment in postwar history, anti-inflation objectives unfortunately probably limit the speed at which we ought to try to recover.

The upshot of all of this—for the purposes of this committee's deliberations—is that over the next 2 to 3 years the pace of economic recovery in the United States from this deepest of postwar recessions will at best be moderate and, barring some major policy changes, may be quite feeble.

Let me turn very briefly to Europe and Japan. To varying degrees Japan and most countries of Europe face the same basic problem as the United States. Some recovery in output is likely to occur over the next several years. But most countries still have a long way to go in putting down inflation and, of necessity, they have limited scope for policies to stimulate a rapid recovery. A few countries like Germany and Japan which have done a good job in preventing or reducing inflation are fearful of going it alone and of rekindling inflation. Their monetary and fiscal policies are also likely to remain very cautious.

But in addition, Japan and a number of the countries of Europe have a major structural problem the United States does not share, or at least not to a major extent.

During the inflation of the past 15 years in many countries wages rose relative to prices in a way that was not warranted by the pace of productivity gains. And despite very large and virtually steady increases in unemployment in Europe over the past 8 to 9 years, the excessive level of wages relative to prices has not fallen very much in many of those countries.

The result has been a structural squeeze on profits. Unless relieved, this squeeze is likely to inhibit the speed of recovery. Investment in new capacity is discouraged; even if sales prospects improve the profitability of the new plants is low. While investment in general is inhibited, much of the investment that does occur is channeled toward labor saving rather than capacity-expanding projects. Labor-intensive industries are particularly penalized, and protectionist sentiment rises.

So, European governments—or at least many of them—have a doubly difficult job. Like the United States, most of them still have a way to go in wringing out a stubborn inflation. But in addition, to promote a privately led and investment-oriented recovery, they must get wage inflation down faster than price inflation in order to restore profit margins.

With great pain and substantial cost the standard policy tools of tight money—and if we had it, tight budgets—can eventually pull down inflation. But we have no reason to believe that those restrictive policies can restore depressed wage-price margins. The problem of excessive wages relative to prices, therefore, may well be an additional factor limiting the speed of recovery in a number of industrial countries.

Let me turn quickly to the developing countries. You know the basic outline of the story, Mr. Chairman.

Recent and prospective economic changes in the developing countries have generated two important sets of economic problems:

First, a major danger for the world financial system has arisen out of large private bank exposure in a few developing countries which, actually or potentially, have not been able to meet their debt obligations on anything like a timely basis.

Second, on a very widespread basis the developing countries of the world are faced with a series of developments—including difficulties in obtaining new credit—which are sharply worsening their own situation and contributing in turn to the general worldwide recession.

The first, or financial structure problem, is a very serious one indeed, but among developing countries it is a highly concentrated one. According to a recent OECD report, private bank exposure in the developing countries is highly concentrated among a relatively small number of countries.

Working out the appropriate debt restructuring for those countries is, and will continue to be, a difficult problem requiring a delicate balancing of sharply conflicting economic objectives and economic interests. Failure to do so, leading to a major debt repudiation, would have extremely severe consequences—quite possibly of a crisis nature—for the world's financial system as well as for the particular countries involved.

While no one can be 100-percent certain in these matters, however, I think that the debt restructuring problem will be worked out despite the difficulties involved. In any event, my own knowledge of the specific circumstances in this area is quite limited. I would, therefore, like to turn to the second major category of economic problems in the developing world, namely the actual and prospective economic difficulties arising out of a shrinking ability to finance needed imports.

Although most of the public attention in the United States has been focused on the first, or financial, problem because of its dramatic nature, the second, or growth problem, is equally serious and far more widespread. The economic growth of developing countries is heavily affected by their ability to finance imports. The major sources of financing are first the receipts from export sales that remain after making debt service payments and, second, net new borrowing.

Developing countries' export earnings have been falling dramatically. The protracted recession in the OECD countries—their main customers—has lowered the volume of exports from developing countries and driven down the prices of the raw materials that comprise an important part of their export earnings. See table 1, page 47.

The relative slowness of recovery that is likely over the next several years in Eurpoe, Japan, and the United States, will have its counterpart in a slow recovery of developing country exports and export prices.

Second, rising debt service. In recent years, debt service requirements have burgeoned for most developing countries. Table 2 [see page 47] sets out some of the major indicators of the worsened debt service picture.

As the last two lines of table 2 will show you, the debt service requirements of the developing countries, as a percentage both of GNP and of their exports, rose only slightly after the first oil shock in 1974 but very sharply after the second oil shock in 1979 and 1980. The reason is not that borrowing expanded more rapidly in the recent period, at least taking these countries as a whole. If you look at line 1 you can see that the rate of increase in outstanding debt grew more after the first oil shock than it did after the second.

Rather, it is the very steep rise in interest rates which distinguishes the recent experience. Much of the external debt of the poorer countries is owed to international institutions like the World Bank and to other governments. Much of it is subsidized and at fixed interest rates.

Rising world interest rates raise the debt service cost of these countries rather gradually. But a very large part of the debt of middle-income and even more so with the rapidly industrializing countries is owed to private banks and increasingly has carried floating interest rates.

Interest rates escalated very rapidly after 1978. The reason was not that private lenders charged a higher premium over market rates, indeed, the premium—until recently—declined somewhat. Rather, it was the very large runup in market interest rates that generated the rise in debt service requirements.

The doubly damaging combination of world recession and shrinking export revenues on the one hand, and the escalation in interest rates on the other, has thus sharply depressed the most important source of import financing for these countries.

Let's look at the availability of private credit. Recent developments in world credit markets have had a mixed, but on balance a substantially negative, impact on the prospective availability of new private credits to developing countries. On the one hand, the highly publicized debt repayment problems of a few major countries, while showing the flow of credits to some Latin American nations, may have diverted credit availability to some other countries.

But this is being more than offset by lenders' awareness of the reduced repayment capabilities of most developing countries. The very rise in current debt service requirements relative to exports that reduces revenues available for financing imports and maintaining growth, also makes it harder for developing countries to tap the other major source of import financing, namely private lending.

Moreover, the general reassessment of risks and tightening up of credit standards occasioned by the recent Mexican, Brazilian, and Argentinian debt problems, is likely to make new private credit generally harder to come by.

There are some positive offsets to these unfavorable elements in the outlook for developing countries. While economic recovery in the industrial nations will be slow, it is likely to begin soon, and at least a modicum of help for sagging LDC exports should be forthcoming. Softening oil prices have lowered and will probably continue to lower import financing requirements. And the fall in interest rates that has occurred in the past 6 months will work its way into lower debt service requirements rather quickly for the more advanced developing countries whose debt is principally of the floating rate variety.

On balance, however, the near-term outlook for the developing countries is bleak.

It is extremely important that the flow of official and private bank credit to the developing countries be maintained at reasonably high levels in the period ahead. This is not only for the sake of the health of the developing countries themselves but also in the interest of the whole world economy, including importantly that of the United States.

Mr. Chairman, I have been prepared to interpolate some estimates that Lawrence Krause of the Brookings Institution has done on the impact, but I gather he is going to testify here this afternoon, so I will leave that to him. Let me simply tell you one of his conclusions. It was published several months ago, he may wish to comment on it this afternoon.

According to Mr. Krause—if I read correctly—if you had a situation in which private bank credit was rolled over but no net new additional credit was issued, so you rolled over all the credit but no new net credit was issued, that would involve about a 3-percent drop in the economic growth rates of the nine oil-developing countries and a 5½-percent drop in the economic growth rate of Latin America, leading to a 1½-percent drop in U.S. growth which in turn—at least I estimate—would mean a loss of about 1 million jobs in the United States, just at a time when we sorely need them.

Maintaining the flow of official and private bank credit is thus very important.

I am not prepared, nor is it my charge at these hearings, to offer specific suggestions about the proper magnitude or the best institutional arrangments through which governments and international institutions—principally the IMF and the World Bank—can help bring this about. Secretary Fowler has set forth a number of excellent suggestions.

There are, however, several very general propositions that flow from the analysis of the world outlook that I have indicated above. I will make three points, very general points, not specific.

First, the same changes in economic policy that the United States ought to take for its own sake, will also directly and indirectly benefit the financial conditions and growth prospects of developing countries.

A combination of reduced Federal budget deficits in the "out" years and responsibily easier monetary policy in the United States through the recovery, could both bring down interest rates and improve the prospects for U.S. economic growth.

This will contribute to lower interest rates directly and indirectly, and to faster growth in Europe and Japan. The faster economic growth would translate into higher export revenues for the developing countries, and the lower interest rates would reduce their debt service. For example, according to the OECD report that I used to put together the earlier tables, a 1-percent reduction in world interest rates would lower annual net interest payments in the four high debt countries by some $1.7 billion—just in the four countries alone.

Second, while better economic policies can improve the pace of economic recovery in the OECD countries over what is now in prospect, that recovery will at best be slow and economic slack will remain relatively high. Unfortunately but inevitably, therefore, the recovery of developing country exports will be quite gradual.

The magnitude and character of any international financial assistance and the provision of private credit ought to be such as to encourage them to undertake such necessary and deliberately paced adjustments in their economies as in many cases will be necessary.

Finally and most importantly, however, Mr. Chairman, it would be economic and political folly either to be so penurious in the scale of credits or so rigorous in its conditions as to force unnecessary and draconian retrenchments upon recipient countries.

The export industries in the United States and other OECD countries are generally at the cutting edge of technological progress and productivity growth. Right now, they have a large overhand of excess capacity and idle workers, and even with good fortune these idle resources will only slowly be absorbed.

Taking the steps necessary to maintain a substantial flow of net new credits to the developing countries will increase the ability of those countries to purchase the output of the export industries. Under current and foreseeable conditions, the additional business will surely not give rise to inflationary pressures but to increased employment.

From the standpoint of many developing countries themselves, there have indeed been some economic excesses which need correcting—in a few cases quite serious ones. But for the bulk of the developing countries a large part of their recently increased economic problems stems not from internal mistakes but from the last oil shock, and from the subsequent prolonged recession and high interest rates in the OECD countries.

Forcing the pace or exaggerating the scale of the adjustments they are required to make, could lead to political instability and would bring about an unnecessary reduction in world economic growth precisely at a time when growth-stimulating forces are most needed.

Thank you, Mr. Chairman.

[Mr. Schultze's prepared statement follows:]

PREPARED STATEMENT OF HON. CHARLES L. SCHULTZE

Mr. Chairman and members of the committee, you have asked the members of this panel to address the topic, "the world economic outlook," as part of a series of hearings to lay the groundwork for considering Administration proposals dealing with the international financial situation.

I am not able to offer you an independent forecast of the world economy. The ones that are available can generally be described, not so much "grim," as "dreary." Some world economic recovery is expected, but not sufficient to ease the huge burden of unemployment in the industrial countries or to eliminate the necessity for some very painful adjustments in the developing nations. I see no reason to quarrel with the latest OECD forecast for its own member countries over the next 18 months. That forecast sees a very feeble recovery in the industrial countries, insufficient to keep unemployment in countries outside Japan, from rising to some 32 million people, or almost 11 percent of the labor force, by the second half of 1983. Economic circumstances for developing countries are also expected to be very difficult over this period, as these countries are forced to reduce their imports, in the light of slow export growth, low prices for those exports, burgeoning debt service requirements, and a reduced flow of new private credits from the advanced countries.

Rather than offer a critique of these short run forecasts, I would like to identify and briefly discuss three economic developments, one each in the United States, Europe, and the developing countries, whose outcomes will importantly influence the evaluation of the world economy between now and the middle of the decade:

1. All of the industrial countries are suffering, and will continue to suffer the pain and costs of wringing out a stubborn, embedded inflation. In the United States, the pursuit of monetary policies that are too high and budgetary policies that are too loose has made, and without a change, will continue to make, the costs of disinflation larger than they have to be. The effects of these mistaken policy choices fall principally on the United States but they are felt throughout the world. Even with a policy correction, however, the pace of economic recovery will have to be relatively modest, compared to earlier postwar recoveries, in the interests of making further progress against inflation.

2. In most countries of Europe and in Japan, but not to a major extent in the United States, the inflation of the past 15 years has been accompanied by an increase in wages relative to prices, well beyond what was warranted by productivity growth. The result has been a major squeeze of business profits, that a mere recovery in business sales will not cure. The standard tools of monetary and fiscal policy may not be able to deal with this problem. Europe and Japan thus face an additional obstacle to sustained recovery that we do not have in the United States.

3. Among the developing countries the combination of steeply rising debt service requirements and a sharp fall in export revenues, occasioned by the world recession, has led to two kinds of problems: First, a large number of developing countries face an increased need for credit just at the time when their private credit worthiness is deteriorating. Without the maintenance of a substantial flow of net new credit, these countries will be forced to undergo a far more drastic set of growth-reducing adjustments than would otherwise be called for. Official assistance in securing such credit should be such in magnitude and in kind as to encourage the kinds of difficult adjustments the recipient countries will unfortunately have to make, in view of the inevitably slow economic recovery in their export markets. Second, in a very few countries, which nevertheless account for an important share of commerical debt, timely debt repayment has become actually or potentially impossible, raising the spectre of financial crisis, and imperatively calling for debt restructuring measures that are difficult to negotiate and which, without great care, can build in bad precedents for the future.

Let me comment briefly on each of these economic problems, their consequences, and try to say something about ways of dealing with them.

THE UNITED STATES

The chief feature of inflation in the United States (and elsewhere) is its "stickiness." Once embedded, it yields only slowly and gradually to restrictive economic policies. Businessmen, labor leaders and workers, faced with shrinking sales, reduce the pace of their wage and price increases only very slowly and reluctantly. As a consequence, when monetary policy is tightened, and the growth of the money supply restricted, for a long time the main consequence is not a large fall in inflation and a small decline in output and employment but the reverse. Output and employment take the brunt of the adjustment. Inflation does eventually yield; and as the pace of wage and price increases moderates even the reduced growth of the money supply will finance a recovery in output and employment. But this process is slow. And if monetary policy tries to clamp down too rapidly it will buy only a modest gain in terms of faster inflation reduction, but a large loss in terms of higher and more protracted unemployment.

It was imperative to halt and then reverse the new surge of inflation that occurred in 1979 and 1980. A major dose of monetary restraint was needed, and was applied beginning in October 1979. And because inflation yields only reluctantly to restraint, output and employment had to suffer. No matter who was President and no matter how adroitly economic policies had been fashioned the control of inflation in the past three years would have brought on a recession. But, in my judgment, monetary restaint was overdone, especially in 1981 and the first half of 1982. Monetary policy attempted too much too quickly; the necessary slowdown in the growth of the money supply took place far too abruptly. (For example, money growth slowed from 7.5 percent in 1979 to 2.3 percent in 1981.) Too much weight was given the argument that inflationary expectations and then inflation itself would quickly evaporate once the Federal Reserve gained credibility in the firmness of its anti-inflationary resolve, and that a sharp reduction in money supply growth would, shortly, have a large impact on inflation and a small impact on output and employment. Too little weight was given to the lessons of history, that inflation yields only slowly and stubbornly to a tightening of monetary policy. The inevitable pain and costs of disinflation were made unnecessarily severe.

More to the point, there is a danger that without a change in the Federal Reserve's attitudes about the stringency of monetary policy, the economic recovery that is about to begin will be unnecessarily feeble and halting. This fear stems from two causes: First, that the underlying rate of inflation will continue to yield only slowly and stubbornly. And, second, that after the current period of temporary ease, the Federal Reserve may well revert to a policy of excessive monetary stringency which does not fully recognize the stubbornness of inflation.

On the surface, inflation has been brought down dramatically. The inflation rate in the consumer price index (CPI) fell from a peak of some 13.3 percent in 1979 to 5.4 percent over the last 6 months. But these numbers, including as they do the effect of volatile and temporary fluctuations in food and energy prices, sharply overstate the magnitude of both the peak and the subsequent decline in the nation's underlying inflation rate. A better rough measure, which abstracts from these temporary fluctuations, is the Department of Commerce's price index for consumer goods excluding food and energy. In that measure, the underlying rate of inflation reached a peak of 9¾ percent in 1980 and fell to a 6½ percent average rate in the 2nd and 3rd quarter of 1982 (the last available data). And even some of that decline reflected the temporary and unlikely-to-be-repeated effect of a large dollar appreciation, which lowered the price of imports and of import-competing goods.

On a conservative basis, then, the underlying rate of inflation is still above 6½ percent. Even with further progress against inflation, it is unlikely to average less than 5½ percent a year over the next several years.

As you know, the Federal Reserve in recent months has temporarily abandoned its earlier announced targets for the growth of the money supply (M1). It took the step partly for technical reasons (changes in banking regulations and financial practices were obscuring the economic meaning of changes in M1). But, more substantively, it wanted to ease up on monetary policy in order to speed economic recovery. The Federal Reserve is unlikely, again for technical reasons, to go back to targeting M1. But if the public pronouncements of Board members are to be taken at face value, the Federal Reserve may revert, once recovery is well underway, to a monetary policy about as restrictive, whatever the technical details, as the policy that was in effect until recently. It is my judgment that such a monetary policy cannot finance both a reasonably paced economic recovery and the stubborn residual inflation that is likely to continue. What would give way in this collision is not principally inflation, but the pace of the recovery. Interest rates would remain high, and could after a time even rise. Output and employment would grow very feebly. Unemployment would fall only a little.

An overly tight monetary policy has been and—without major changes—will continue to be accompanied by an overly loose budgetary policy. The huge budget deficits, that threaten to continue growing throughout the recovery, will indeed provide some economic stimulus, principally in the consumer goods and defense industries.

But at the same time, the higher interest rates, occasioned as the burgeoning deficits collide with tight money, will retard recovery in the already depressed interest-sensitive industries such as autos, housing, and investment goods. Moreover, current expectations that the problem will grow worse over the years ahead helps prop up today's long term interest rates. And finally, quite apart from current problems, huge long term budget deficits tend to give us an economy structurally biased against productivity-improving investment.

Two changes in economic policy are thus necessary. Neither, taken by itself will be sufficient or even appropriate. Monetary policy over the next several years should be designed to accommodate a sustained moderate recovery at gradually declining inflation rates. But the Federal Reserve must do so in a way which preserves the credibility of its anti-inflationary resolve, so as to have the desired effect on medium and longer term interest rates. It can do so with the greatest chance of success if its actions are taken in concert with a series of substantial and realistic legislative measures that very substantially reduce the long term budget deficit.

Reducing the long term budget deficit will require tax increases and spending cuts. The smaller deficits will lead to lower interest rates, and better growth for the interest-sensitive industries. But unless at the same time monetary policy is deliberately made less restrictive, that improvement will be more than offset by the depressive effects of the tax increases and expenditure cuts on industries producing consumer and defense goods. Budgetary and monetary policies both need to be modified.

Even with the best economic policies, however, the United States cannot afford, and is unlikely to achieve an economic recovery as vigorous as those which typified earlier recoveries of the postwar period. As I pointed out earlier, the underlying rate of inflation remains high, and it is essential that we get it down further. This requires caution. We cannot afford to go too fast, so as to risk a reacceleration of inflation. Typically in the first 2 years of previous postwar recovery, economic growth averaged 5 to 6 percent a year. This time we would not want to aim for more than 4½ to 5 percent. And so although we start with the largest slack and the highest unemployment in postwar history, anti-inflation objectives limit the speed at which we ought to try to recover.

The upshot of all of this, for the purposes of this committee's deliberations, is that the pace of economic recovery in the United States from this deepest of postwar recessions will at best be moderate, and barring some major policy changes, may be quite feeble. Such an outlook has obvious implications for the future export growth, internal adjustment requirements, and credit needs of the developing countries. But before commenting on this, let me turn very briefly to the recovery prospects for the other industrial countries.

EUROPE AND JAPAN

To varying degrees Japan and most countries of Europe face the same basic problem as the United States. Some recovery in output is likely to occur over the next several years. But most countries still have a long way to go in pulling down inflation, and of necessity they have limited scope for policies to stimulate a rapid recovery. A few countries like Germany and Japan which have done a good job in preventing or reducing inflation are fearful of going it alone and of rekindling inflation. Their monetary and fiscal policies are also likely to remain very cautious.

But in addition, Japan and a number of the countries of Europe have a major structural problem the United States does not share. During the inflation of the past 15 years wages in many countries rose relative to prices, in a way that was not warranted by the pace of productivity gains. In the late 1960's there was an explosion in wage costs in Europe that was not fully passed on in prices. After the first oil shock in 1974, workers in these countries, unlike their U.S. counterparts, insisted on and got wage increases to match the rise in energy prices, and part of these wage increases came out of profits. Experience in most countries was better after the second oil shock, but the earlier excesses were not eliminated. And despite very large and virtually steady increases in unemployment in Europe over the past 8 to 9 years, the excessive level of wages relative to prices has not fallen very much in many of these countries.

The result has been a structural squeeze on profits. Unless relieved, this squeeze is likely to inhibit the speed of recovery. Investment in new capacity is discouraged; even if sales prospects improve the profitability of new plants is low. While investment in general is inhibited, much of the investment that does occur is channeled toward labor saving rather than capacity expanding projects. Labor intensive industries are particularly penalized, and protectionist sentiment rises.

European governments thus have a doubly difficult job. Like the United States, most of them still have a ways to go in wringing out a stubborn inflation. But in addition, to promote a privately led and investment-oriented recovery they must get wage inflation down faster than price inflation in order to restore profit margins. With great pain and substantial cost the standard policy tools of tight money and tight budgets can eventually pull down inflation. But we have no reason to believe that restrictive policies can restore depressed wage-price margins. In some countries—notably Great Britain and Germany there appears to have been some improvement recently. But the problem of excessive wages relative to prices may well be an additional factor limiting the speed of recovery in a number of industrial countries.

DEVELOPING COUNTRIES

Recent and prospective economic changes in the developing countries have generated two important sets of economic problems. First, a major danger for the world financial system has arisen out of large private bank exposure in a few developing countries which, actually or potentially, are not able to meet their debt obligations on anything like a timely basis. Second, on a very widespread basis, the developing countries of the world are faced with a series of developments—including difficulties in obtaining new credit—which are sharply worsening their own situation and contributing in turn to the general worldwide recession.

The first, or financial structure problem, is a very serious one indeed. But, among developing countries, it is a highly concentrated one. According to a recent OECD report, private bank exposure in the developing countries is highly concentrated among a relatively small number of countries. Four countries—Mexico, Brazil, Argentina and South Korea—account for more than half of the total outstanding liens of private banks to the non-OPEC developing countries, and 85 percent of the net floating interest debt (where recent increases in interest rates have particularly raised debt service burdens). Net bank "exposure" (outstanding debt less borrower country deposits) is even more highly concentrated than the debt itself.

Working out the appropriate debt restructing is, and will continue to be a difficult problem, requiring a delicate balancing of sharply conflicting economic objectives and economic interests. Failure to do so, leading to a major debt repudiation, would have extremely severe consequences, quite possibly of a crisis nature, for the world's financial system, as well as for the particular countries involved. While no one can be 100 percent certain in these matters, however, I believe that the debt restructuring problem will be worked out, despite the difficulties involved. In any event, my own knowledge of the specific circumstances in this area is quite limited. I would, therefore, like to turn to the second major category of economic problems in the developing world, namely the actual and prospective economic difficulties arising out of a shrinking ability to finance needed imports.

Although most of the public attention in the United States has been focused on the first, or financial, problem because of its dramatic nature, the second, or growth problem is equally serious, and far more widespread. The economic growth of developing countries is heavily affected by their ability to finance imports. The major sources of financing are first, the receipts from export sales that remain after making debt service payments, and second, net new borrowing. Several developments have been seriously eroding the import capability, and harming the growth potential of most developing countries.

1. Their export earnings have been falling dramatically.

The protracted recession in the OECD countries, their main customers, has lowered the volume of exports from developing countries and driven down the prices of the raw materials that comprise an important part of their export earnings. (See table 1.)

The relative slowness of recovery that is likely over the next several years in Europe, Japan, and the United States will have its counterpart in a slow recovery of developing country exports and export prices.

TABLE 1.—EXPORTS OF NON-OPEC DEVELOPING COUNTRIES

[Annual percent change]

	1970-73	1973-78	1978-80	1981	Estimated 1982	Projected 1983
Export revenues	23	19	27	5	−6	1
volume	10	6	9	10	3	3
prices	12	13	18	−5	−8	−2

Source: OECD, External Debt of Developimg Countries, 1982 Survey, December 1982.

2. Rising debt service

In recent years debt service requirements have burgeoned for most developing countries. Table 2 below sets out some of the major indicators of the worsened debt service picture.

As the last two lines of table 2 indicate, the debt service requirements of the developing countries as a percent both of GNP and of exports, rose only slightly after the first oil shock (1974), but very sharply after the second (1979-80). The reason is not that borrowing expanded more rapidly in the recent period. Indeed, it rose somewhat less (see line 1). Rather, it is the very steep rise in interest rates which distinguishes the recent experience. Much of the external debt of the poorer countries is owed to international institutions like the World Bank and to other governments. Much of it is subsidized and at fixed interest rates. Rising world interest rates raise the debt service cost of these countries rather gradually. But a very large part of the debt of middle-income and even more so of the rapidly industrializing countries is owed to private banks and increasingly has carried floating interest rates. Those rates escalated very rapidly after 1978. The reason was not that private lenders charged a higher premium over market rates—indeed the premium declined somewhat. Rather it was the large runup in market interest rates that generated the rise in debt service requirements.

TABLE 2.—DEBT, DEBT SERVICE, AND INTEREST COSTS, NON-OPEC DEVELOPING COUNTRIES

	1970-73	1973-78	1978-80	1981	Estimated 1982
	Annual percentage change				
Outstanding debt	17	23	17	16	17
Gross interest payments	20	27	44	31	25
	Percent				
Average interest cost	[1] 5	[2] 6	8	10	11
On floating interest debt	[1] 8	[2] 9	14	17	17
Debt service as percent of:					
GNP	2.2	2.9	3.8	4.1	4.3
Export revenues	14.0	15.1	17.0	19.0	21.0

[1] 1972-73.

[2] 1974-78.

Source: See table 1.

The doubly damaging combination of world recession and shrinking export revenues on the one hand and the escalation in interest rates on the other has thus sharply depressed the most important source of import financing for those countries.

3. The availability of private credit

Recent developments in world credit markets have had a mixed, but on balance a substantially negative impact on the prospective availability of new private credits to developing countries. On the one hand the highly publicized debt repayment problems of a few major countries, while slowing the flow of credit to some Latin American nations may have diverted credit availability to some other countries. But this is being more than offset by lenders' awareness of the reduced repayment capabilities of most developing countries. The very rise in current debt service requirements relative to exports that reduces revenues available for financing imports and maintaining growth, also makes it harder for developing countries to tap the other major source of financing, namely private lending. Moreover, the general reassessment of risks and tightening up of credit standards occasioned by the recent Mexican, Brazilian, and Argentinian debt problems, is likely to make new private credit generally harder to come by.

There are some positive offsets to these unfavorable elements in the outlook for developing countries. While economic recovery in the industrial countries will be slow, it is likely to begin soon, and at least a modicum of help for sagging LDC exports should be forthcoming. Softening oil prices have lowered and will probably continue to lower import financing requirements. And the fall in interest rates that has occurred in the past 6 months will work its way into lower debt service requirements, rather quickly for the more advanced developing countries whose debt is principally of the floating rate variety.

On balance, however, the near term outlook for the developing countries is bleak. While there have clearly been a number of instances of excessive and consumption-related borrowing, lax credit screening, and poorly designed investment projects, for the large majority of developing countries the problem stems mainly from the combination of deep recession, slow recovery, and high interest rates in the OECD countries.

It is extremely important that the flow of official and private bank credit to the developing countries be maintained at reasonably high levels in the period ahead. I am not prepared—nor is it my charge at these hearings—to offer specific suggestions about the proper magnitude, or the best institutional arrangements through which governments and international institutions, principally the IMF and the World Bank, can help bring this about. There are, however, several very general propositions that flow from an analysis of the world economic outlook which may be useful to the Committee.

First, the same changes in economic policy that the United States ought to take for its own sake, will also directly and indirectly benefit the financial conditions and growth prospects of developing countries. A combination of reduced Federal budget deficits in the "out" years and responsibly easier monetary policy in the United States could both bring down interest rates and improve the prospects for U.S. economic growth. This will contribute to lower interest rates and faster growth in Europe and Japan. The faster economic growth would translate into higher export revenues for the developing countries and the lower interest rates would reduce their debt service. For example, according to the OECD report cited earlier, a 1 percent reduction in world interest rates would lower annual net interest payments in the four high debt countries alone by $1.7 billion.

Second, while better economic policies can improve the pace of economic recovery in the OECD countries over what is now in prospect, that recovery will at best be slow and economic slack will remain relatively high. Unfortunately, but inevitably, therefore, the recovery of developing country exports will be quite gradual. The magnitude and character of any international financial assistance and the provision of private credit ought to be such as to encourage them to undertake the necessary and deliberately paced adjustments in their economies that in many cases will be necessary.

Finally, however, it would be economic and political folly either to be so penurious in the scale of credits or so rigorous in its conditions as to force highly ambitious and draconian retrenchments upon recipient countries.

The export industries in the United States and other OECD countries are generally at the cutting edge of technological progress and productivity growth. Right now they have a large overhang of excess capacity and idle workers, and even with good fortune these idle resources will only slowly be absorbed. Taking the steps necessary to maintain a substantial flow of net new credits will increase the ability of the developing countries to purchase the output of those export industries. But under current and forseeable conditions the additional business will surely not give rise to inflationary pressures.

From the standpoint of many developing countries themselves, there have indeed been some economic excesses which need correcting, in a few cases quite serious ones. And, as I said earlier, there are some painful adjustments to be made generally. But for the bulk of the developing countries a large part of their recently increased economic problems stems not from internal mistakes but from the last oil shock, and from the subsequent prolonged recession and high interest rates in the OECD countries. Beyond a certain limit, forcing the pace or exaggerating the scale of the adjustments they are required to make could lead to political instability and would bring about an unnecessary reduction in world economic growth precisely at a time when growth-stimulating forces are most needed.

Senator **Mathias**. Thank you very much, gentlemen.

Let me say at the risk of breaching a confidence—although this was not placed off the record during this conversation—but at the time the announcement was made that these hearings would be held and that you would be here as witnesses, a member of the press said, "Why are you having those fellows?" He said, "They are the ones that got us into trouble in the first place." [Laughter.]

Well, I hope that that member of the press has heard every word that has been spoken here this morning. I think it is patently clear why we asked you here because I cannot imagine a more comprehensive and knowledgeable, and thoughtful discussion of these problems than you have given us. I want to thank you for it.

Secretary Fowler in his statement, referring to the borrowings by developing countries, says that, "These borrowings were particularly heavy in the relatively unregulated Eurocurrency and offshore markets through syndicated bank loans arranged by the larger banks or bank consortia, but including in these syndicates a far larger number of smaller banks in the developed countries."

Now, what does that really mean for the average American, what kinds of problems do you see that creating? We have all leaned over backward here today to say we are not expecting a wave of bank failures and we are not. But what kinds of problems does that situation create?

Mr. **Fowler**. I think the major problem it creates is, of course, a concern in the communities of the, say, 1,400 banks in the United States and some of the other countries which participated in the lending to Mexico, as to whether or not the spread of a default on those loans would impair their capital structure and their ability to perform their services in the domestic economy which is involved.

The impact of a failure to deal with this problem, looked at in terms of very cold self interest in the communities served by the hundreds of U.S. banking institutions which are involved in this process I think was very well developed by Secretary Donald Regan in his statement before the House Banking Committee on December 21.

He said,

> One way to look at this question is to ask what the implications are for workers in Providence or Woonsocket if foreign borrowers do not receive sufficient assistance to adjust in an orderly way.
>
> What if they are late in making interest payments to banks or cannot pay principal, and loans become nonperforming or written off as a loss?
>
> If interest payments are more than 90 days late, the banks stop accruing them on their books. They suffer reduced profits and bear the costs of continued funding of the loan. Provisions have to be made for loss. As loans are actually written off, the capital of the bank is reduced. This, in turn, reduces the banks' capital-asset ratio which forces banks to curtail lending to individual borrowers and lowers the overall total they can lend.
>
> The reduction in the amounts banks can lend will impact on the economy; so will the banks' reduced ability to make investments, which in everyday language includes the purchase of municipal bonds which help to finance the operation of the communities where individual Americans work and live. Reduced ability to lend could also raise interest rates.
>
> I want to make it very clear, that we are not talking here just about the big money center banks and the multinational corporations. Well over 1,500 U.S. banks, or more than 10 percent of the total number of U.S. banks, have loaned money to Latin America alone. They range in size from over $100 billion in assets to about $100 million. These banks are located in virtually every state, virtually every congressional district, and in virtually every community of any size in the country.

Those loans, among other things, financed exports—exports that resulted in jobs, housing, and investment being maintained or created to the United States.

Then he goes on to further develop it. But that is the essence and flavor, I think, of what I would also see as the most direct impact of a failure to deal with the problem along the lines that we have discussed.

Senator MATHIAS. Mr. Schultze?

Mr. SCHULTZE. I get into this with a little bit of trepidation but let me make a point. It seems to me that there are two different kinds of problems. One, how do you deal with the current situation and, two, what reforms might be made for the future to give us kind of a better basis to work with.

This is where I think that Secretary Fowler's point No. 5, I believe it was, essentially the need for developing some systematic, probably institutionalized means, of coordination between private banking systems and the official institutions.

Let me note that in the years 1979, 1980 and 1981 the cumulative OPEC surplus was $244 billion. That could not be shoved under a mattress, that had to be recycled back through both the developed and the less developing countries.

On the one hand, you surely did not want it all done by governmental institutions for all sorts of reasons. On the other hand, it is my judgment that leaving it completely in the hands—very heavily in the hands—of the private banking system without means of coordination—particularly at a time when participation is spreading widely—is something that from hindsight we probably could have done better and probably ought to think about in the future how to merge the two sets of considerations which are involved.

Now, I would hope that a big OPEC surplus like that never develops again—for the obvious reasons. But the problem will be with us in the future.

Mr. FOWLER. That is why I included President Tony Solomon's statement in October, which addressed itself to the future after we deal with the problem at hand. We will have had a lot of experience currently and in the months ahead to find out what the problems were, what the weaknesses were in the system of supervision or the system of coordination between, let's say, the IMF and the private international banking system.

Secretary Solomon, for example, suggests the need for some overall guidelines as to a reasonable pattern of global account positions and of the financing of imbalances that would occur of a substantial nature, and that those guidelines would be of great assistance to the international banking system in performing its appropriate function.

Also some knowledge of when it is wise for the banking system again to put the brakes on additional lending when there is no adjustment process, apparently, in the borrowing country in dealing with the problem. When it would be appropriate for that country to move to the IMF and to work out an adjustment program which in turn could give the private banking system a bit of a base on which to make their judgments as to their part of the play.

I think what Charles Schultze has said of some better method of coordination between the IMF and the private banking system, and the bank supervisory authorities, some of that is on the way. I think in a sense more of it has been done than we know about in that regard. But certainly, we need to identify and to solidify that type of coordination more than is apparent today.

Senator **Mathias**. Secretary Blumenthal, do you have any comments on that question?

Mr. **Blumenthal**. No; I think it has been very well stated.

Senator **Mathias**. I have just one further question. I am interested that very little emphasis has been placed this morning on the problems of currency exchange. In Europe there is a considerable complaint that the dollar is overvalued, reflecting at least in part high interest rates here.

Is this a justified complaint? Are the sharp fluctuations in currency values a part of the problem, and is there any way to manage these fluctuations, if not totally at least within some extreme limits?

Mr. **Fowler**. Dr. Blumenthal referred to that. I did not in my oral statement but in my written statement in part II, the specific analysis.

In analyzing what the problems are that have been associated with this chronic addiction to inflation, excessive inflation at various times during the past decade or so, I mentioned a number of items.

Item "d" is instability and excessive volatility in key exchange rates, resulting in part from highly variable rates of inflation, interest rates and economic activity, and in part from speculative market forces, resulting in substantial overvaluation and undervaluation among currencies of the major industrial countries with a considerable resulting distortion on the behavior of prices and foreign trade.

It is quite a technical problem, Mr. Chairman, but it is one which you very properly raised. I do not think time has simply permitted us to develop it. Certainly, in my statement I feel it is underdeveloped.

Senator **Mathias**. Thank you.

Mr. **Fowler**. I think there will be a report of the Atlantic Council forthcoming in the next week or 10 days which focuses very heavily on this problem of excessive volatility and spells of overvaluation and undervaluation in exchange rates, and what the impact of that has been in distorting trade.

I think more could be done. I for one happen to believe that the coordination of fiscal and monetary, and economic policies generally between the major key currency powers—that is the five countries whose currencies are a part of the SDR—could have over the years past, reduced the amount of this—I guess you would say the excesses in the movement of market rates in the exchange area.

Senator **Mathias**. Secretary Blumenthal?

Mr. **Blumenthal**. Mr. Chairman, I think you are quite right that this matter of excessive exchange rate fluctuations has been an additional disturbing element on the international scene of the last several years.

You point out that the Europeans complained about an excessively overvalued dollar in the recent past. Not too long before that, I was in the Treasury and Mr. Schultze was over in the Council, they were complaining bitterly about an excessively undervalued dollar.

I think there are two elements that have contributed to these very substantial fluctuations of recent years. One of them is merely the relentless advance of technology, coupled with the much greater interrelationship of the major economies as compared to 20 or more years ago.

Exchange markets never close, they are all tied together with electronic funds transfers. Knowledge and communication is instantaneous these days. That, clearly, is a complicating factor.

There are also now very large resources that can move around very rapidly outside the United States in the Eurodollar markets and elsewhere.

The second element, of course, is the fact that since the end of the Bretton Woods system we really have not had any kind of structural or formal system, or rules of the game, in dealing with these problems. We have essentially relied on free market forces, but these have been overshadowed by very rapid, often speculative, movements which tend to overshoot in either direction, when the stampede begins.

I think, as Secretary Fowler said, to deal with this problem is a highly complex technical matter. There are a number of groups working on this. The Atlantic Council is one. I think the "Group of Twenty-Five" it calls itself, composed of 25 practitioners in this field and experts, has also been working on this problem to try to see whether or not there is not some greater discipline through more formal coordination arrangements that can be brought into this.

The third factor—I would have to add—in the recent past has been the regrettable, and to me somewhat perplexing unwillingness of the U.S. Treasury until the very recent past—I think they did so toward the end of last year—to enter the exchange markets at all.

And while no one would claim that Central Bank or Treasury intervention in the foreign exchange markets can deal with fundamental trends, certainly, a kind of a smoothing out and discouraging of speculators by keeping them off base is very possible.

Not to do so and to announce that you will not do so, was a mistake because it tended to exacerbate somewhat the problems we faced.

So, I think it is an area that requires attention and coordination, and study by the various countries. I think we ought to try over the next several years to move to a somewhat more orderly system of rules of the game and coordination.

Mr. **Fowler**. The summit meeting last year, Mr. Chairman, did set up this group that I referred to in my statement to look at the problems of coordinating monetary policy.

That group has focused primarily, I think, on the question of, is it possible to deal with the excessive market forces that produced the excessive volatility in exchange rate movements.

I think there are two aspects of the problem. As Mr. Blumenthal indicates, the posture up to now has been that the markets, or the speculator forces, simply have a free ride if there is a public attitude that there will be no coordinated intervention to deal with what the authorities think is an excessive movement.

The second and perhaps the most important aspect is that a better coordination of national economic policies of the major key country currencies to deal with the excesses of inflation would have the secondary and very desirable effect of diminishing over time this volatility in exchange rate movements. It would not eliminate it all, but it would hopefully make it less meaningful.

Senator MATHIAS. Secretary Blumenthal's comment that the exchange windows are open 24 hours a day all the way around the world recalls Dean Rusk's statement that: "The trouble with the world is that it is round and that the Sun is always shining on some troublemaker somewhere." [Laughter.]

Senator Pressler?

Senator PRESSLER. Thank you, Mr. Chairman.

Let me say that in listening this morning, it has occurred to me that perhaps the world is on the verge of a new "Dark Age" so to speak. I hope that is not the case, and I know that the witnesses are more optimistic.

The fact of the matter is that we have no arms control agreement or any in sight. That is a subject separate from what we are discussing here today.

Also, as has been pointed out, the population growth exceeds GNP growth in many countries of the world, as Mr. Blumenthal said so well.

Recently, I have been doing a study of agriculture, and worldwide, it is going backwards rather than forward in terms of productivity. And, indeed, even in our own country, although it is very productive, we may be depleting the soil and developing a corporate form of agriculture that will not be so productive. But worldwide it is a very grim picture.

On top of that is the debt structure of many countries that has been described here this morning—countries which have corruption and other problems.

The interest rates of Western democracies have been mentioned here this morning. I recently have had a study done on what the interest rates are in the Western democracies and they are all high, higher than ours. Perhaps we should have an international monetary conference on what can be done about interest rates.

But the point is, it is a very grim picture. And maybe when I say we have a coming "Dark Age" economically and otherwise, with just tiny islands of prosperity, maybe that is what we already have.

But I listened with some interest because there seemed to be notes of hope. It has been said that the problems are "manageable." But looking at this array of problems I think we are on the very verge of a collapse in our economic system.

Is my assessment too grim?

Mr. FOWLER. I would say it is. I think you are quite right that there are plenty of things going on out there to give rise to gloom. There is also a great deal that is in place that gives rise to optimism.

Without being sacrilegious, I would recall a story I think Herman Kahn once told about the sixth day of creation. The Creator turned to the rabbi and said, "Well, what is your feeling about the outlook?" He said, "Well, I am optimistic."

"Well," he said, "what is that furrowed look on your brow?" He said, "I am worried because I am optimistic." [Laughter.]

I think there is a good deal of this going around.

The reason I am optimistic, although very worried as the contents of my statement will indicate, is that we have seen in the postwar period, in the late forties and the early fifties, the beginning of a process of coordination between the major industrialized democracies in the world which has, over the last 20 years, 30 years now in fact, steadily grown and developed.

The institutions that Secretary Blumenthal referred to that were set up in the late forties have matured. They have received an increasing degree of support and reliance, and there is a rapidly advancing pattern, certainly, within the major ministries in the governments of dealing with their opposite numbers in other countries.

I recall an interest rate disarmament conference at Chequers, England, in 1967 to deal with a problem at that time where we needed, we felt, to have low interest rates but we could not lower ours and cause a large outflow of funds when interest rates in our trading partners were at a much higher level. So, that Chequers conference has had many duplicates since.

In 1973 a "Group of Five," the so-called George Shultz group, was set up. That has matured into the business of economic summits. While there is a good deal to decry about economic summits, the fact that they exist and the fact that one is scheduled, and the fact that people are being concerned in each of the major governments as to what will be discussed here in May, and people being concerned about what action will be taken, is to me a hopeful institutional development. I think we need more of it and it needs to be done more effectively.

Mr. **Blumenthal**. May I just add one point to this, Mr. Chairman.

I think to talk about impending collapse is to exaggerate and to run the risk of this becoming a self-fulfilling prophecy. I think we need to be very careful in the way in which we view the situation and in the way in which we describe it. Words like "crisis" and "collapse" I think do not serve us well.

I think it is quite possible, Senator Pressler, to consider any number of "ifs"—if the commercial banking system pulls back; if the resources of the IMF cannot be increased; if we do not get our economic house in order in the United States, et cetera, in such circumstances clearly the situation could get worse rather than better and we could be in even more serious difficulties. But it need not happen.

I think the encouraging thing is that we have the institutions in place to deal with these problems, as Secretary Fowler has said.

Second, the general outline of what needs to be done, I think, is generally speaking, understood amongst the major actors. And while there is obviously disagreement as to certain of the specifics and the details, in overall terms I do not detect a great deal of controversy about what needs doing.

I think what is required simply is that none of us cut and run; that all of us recognize that the international institutions and we individually, have a role to play. That there is a general outline of what needs to be done; that we get on with doing it. We have had plenty of experience in the postwar period of resolving some of the most difficult and challenging economic issues before us.

If you look at the trade conferences that have taken place over the years—I was involved in the "Kennedy Round." A lot of people said it could not be done because of the diverging interests of too many countries. Well, we did it. We did after 4 difficult years come to what has turned out to be a good agreement which benefited the world.

We said we could not do anything about raw material prices in the early sixties. Well, we did through collaboration, put in place a number of measures that stood us in good stead for a great many years.

And we have after all, looking back, in the financial area, in the investment area, in the technology area, over the years managed, through international collaboration, to solve our problems. So, here again, I think to talk of impending collapse is to exaggerate.

But it does require wisdom and intelligent action by all of us.

Senator **Mathias**. Do you have any further questions, Senator Pressler?

Senator **Pressler**. No. Thank you.

Senator **Mathias**. Senator Proxmire.

Senator **Proxmire**. Thank you, Mr. Chairman.

First, I forgot to congratulate Charlie Schultze on being the new president of the American Economic Association. That is the best decision they have made in years.

I remember the one truly distinguished economist we have had to serve in the U.S. Senate was Paul Douglas, who was also president of the American Economic Association. I think it is a great tribute to you.

I have always thought you were a great economist, but it is good to have your peers recognize your distinction. You serve in a position that really outstanding people who have helped the Congress so greatly have served in, and I know of nobody who has helped the Congress more than you have in the years I have been here.

Now, let me turn to my good friend, Mr. Fowler. Mr Fowler, you said 1,200 American banks apparently have loaned to LDC's.

Mr. **Fowler**. I have understated it; it is 1,500.

Senator **Proxmire**. 1,500 American banks have loaned to LDC's, and some might be in some jeopardy if the LDC's are not assisted—at least that is the implication of what you said. And the inference was that people who borrow from these banks—the homebuilders, the auto buyers, the small businessmen, and the farmers and so forth—might be in difficulty.

It seems to me that the amount of credit available in our society does not depend on what happens to even 1,200 banks. I think you would agree with me that all 1,200 of those banks are not going to be in serious jeopardy, no matter what happens.

It has always been my understanding that the amount of credit available is not the function of whether several banks are in difficulty. That might have some effect in some communities but it would not be the principal force.

Furthermore, to the extent that the banks find that they cannot make these loans abroad without running a risk—something they have not been so sure of before, that they are not going to be bailed out—would not that tend to make them more likely to make credit available to domestic borrowers instead of to foreign borrowers?

Would not a bank in Milwaukee, Wis., be likely to say, "Well, I am not going to make a loan to Brazil or to Mexico. I always thought that would be taken care of by some international organization or a bailout by the Federal Government. If they are not going to do it, we concentrate our lending in Wisconsin."

What is the answer to that?

Mr. **Fowler**. It might very well be the reaction. I think it would be a very unfortunate reaction for the overall national interest.

Senator **Proxmire**. I realize that. First, let me make sure that I understand, then. At least the immediate effect might be that there would be more credit available domestically. Is that right or wrong?

Mr. **Fowler**. I do not know. Fear is a difficult phenomenon. Whether the appearance of some bank's failing would have a kind of a fallout in the activity and operations of many of the banks who still were there because these problems that we now have been talking about primarily in terms of the nonoil-producing developing countries, of failing companies and of entities in difficulty, have their counterparts here at home.

I think what we have to be concerned about, and to fight, is any impression becoming imbedded in our communities that we are on the verge of a major collapse.

As Senator Pressler, I think, indicated and as Secretary Blumenthal replied, we have to look at this problem of international debt as something that is related to our own situation here at home and indeed related to the problems of domestic debt.

I am not talking about solvency and rescuing people from bad management. I am talking about liquidity and credit, and the availability of a lender of last resort to deal with liquidity problems—which is what this situation primarily is.

Senator **Proxmire**. Let me get a response to what is bothering me. Perhaps I can use an editorial from the Wall Street Journal which has a simplification worthy of the McLaughlin group.

Mr. **Fowler**. Last week's editorial?

Senator **Proxmire**. January 2. I think it is something that you gentlemen are equipped to answer. Let me read a couple of the most graphic sentences.

> The debtors [speaking of the LDC borrowers] the debtors have been quick to learn that despite their mismanagement and worse the money spigot is still open, perhaps not at the old, wide-open level but enough to ensure a pretty substantial flow of fresh funds nevertheless.
>
> With any debtor in trouble, the banks must make the difficult judgment whether a work-out is possible or whether they would just be throwing good money after bad.
>
> The trouble is that the banks do not appear to be making that kind of judgment. And the bank regulators do not seem to be forcing them to do so. The same blinker game is continuing and banks are refusing to act like bankers.
>
> We would feel a lot better about those extra billions that the banks want the taxpayers to give to the IMF to fuel more such operations if we saw some evidence that the banks and the regulators—who for years have been allowing the banks to get

away with thinking that lending at a few points over the London bank rate to every tin-pot country that came down the pike was real banking—were facing up to their mistakes.

Somewhere, we keep hoping, there must be a banker willing to say "the Emperor has no clothes," perhaps by declaring an outright default on the country loan. Until then, we really cannot blame the Poles or the Romanians, or the Brazilians for treating the whole bunch like suckers.

What is the answer to that?

Mr. **Fowler**. I think the answer—I tried to approach this in item 8 of my series of recommendations in my statement. I had to skip some of my comments in the interest of time.

But I said in this business of what the role of government and central banks should be, bank regulatory authorities of the developed countries whose domestic commercial banks and their external subsidiaries or affiliates where they are involved,

> While each central bank would have responsibility for the banks in their own country and their external affiliates, it should be part of an agreed collective action by the major banking nations that will cover adequately the net work of involved institutions and thereby avoid the chain reaction of major bank difficulties.

This is to avoid a fire storm arising out of the current situation.

Returning to the statement,

> This action will help to avert any deterioration in the effectiveness of the private international banking system to provide the new money that will be necessary to lend to the Third World to sustain their economies through the adjustment period ahead and restore stability and promise through the historic process of encouraging Third World development through lending from external sources.
>
> As a corollary to this undertaking, it would be appropriate for the governments involved, working with the International Monetary Fund, to indicate the amounts of future private lending to major or financially troubled borrowers necessary or desirable in the general interest of developed countries and private banks alike.
>
> This facet of a coordinated current stabilization program will be helpful in connection with the study recommended above concerning ways and means of preventing a recurrence of the present crisis long after it has become a page of history.

That is a reference back to the recommendation No. 7 about the study of how we can learn to deal with and prevent this kind of a problem in the future from what has been happening over the last 7 or 8 years.

Tony Solomon's very interesting statement—which I include as an exhibit to my statement—goes into that in some detail. The essence of which is that the private banks by diversifying their risk, by lending to a number of countries and by diversifying their risk by having through the syndicated bank loan device a number of other banks share their risk with them, have felt that they have sufficiently followed careful policies of banking in dealing with the problem.

But what they were not prepared to deal with, and I think would all admit they would not be prepared to deal with, would be something in the way of an international breakdown in which a number of the major borrowing countries would go belly-up in the sense of not being able to pay either the principal or the interest, and you would have a major default.

Now, a major default of three or four important countries could have a very damaging effect. And that is the kind of situation which you want to be able to prevent by action different, perhaps, from what we have followed in the last 7 or 8 years.

Senator **Proxmire**. Secretary Fowler, should not those reforms be in place before the IMF quota is approved?

Mr. **Fowler**. I do not know that time permits.

Senator **Proxmire**. Well, that is when we have our leverage, do we not?

Mr. **Fowler**. The study should be inaugurated right now as to what should be done. The study should be carried on simultaneously with the process because that is when everybody is alive and acute, and people are more sensitive to what has been done and what has not been done.

Senator **Proxmire**. And how do we explain to the borrowers in this country, when these foreign countries that seem to be in difficulty are able to borrow money from the IMF at 6½ percent—this money, as I understand, would be available at 6½ percent rather than at the market rate that a borrower, a domestic borrower who may be perfectly sound, who may have a fine record would have to borrow at 15, 18, 20 percent.

Mr. **Fowler**. Well, let me just say that the lending by the IMF is not to a private company or an enterprise.

Senator **Proxmire**. I understand.

Mr. **Fowler**. It is to a government.

Now, what that going interest rate is, you know more than I do. I am not at the IMF.

Senator **Proxmire**. The testimony we have had from the Treasury in an informal meeting before the Senate Banking Committee about 3 or 4 days ago was that it was 6½ percent.

Mr. **Fowler**. I think the principal point I would make is, the distinction is between the lending to governments and the lending to private enterprise.

Now, in this country the closest parallel to that 6½ percent would be what the discount rate is at the Federal Reserve Bank level.

Senator **Proxmire**. It is still higher than 6½ percent.

Mr. **Fowler**. Marginally higher, but not all that great a differential.

Senator **Mathias**. Before we get too far from this point, the question of solvency and liquidity and the distinction between them has come up recurrently.

Secretary Blumenthal mentioned it in his statement and I wondered if you would want to just give us a short definition so that the record is clear on that point.

Mr. **Blumenthal**. I may not be able to give you a technical definition but I can give you a commonsense definition.

Senator **Mathias**. That is the only kind we are equipped to handle here.

Mr. **Blumenthal**. I think of insolvency as a situation in which the liabilities on a permanent basis exceed the assets, where there is no likely way in which the balance between the two can be reestablished.

Senator **Mathias**. Your definition of solvency really is the basis of assessing the banker's judgment in going into the transaction in the first place.

Mr. **Blumenthal**. Well, both of course, Mr. Chairman. I suppose a prudent banker looks not only at whether or not a potential borrower is likely to be insolvent but also what the liquidity situation is going to be in order to service his debt.

I think what we face in a country like Brazil, which has enormous resources and has had a major development effort underway, is clearly not an insolvent economy.

We have an "iliquid" situation where the cash required for a temporary period is not available—for the reasons that have been outlined here and discussed this morning—due to some temporary factors that can be overcome.

Mr. Schultze.

Senator **Proxmire**. Before Mr. Schultze answers that, I just wanted to point out that the comparable rate, the 10-year U.S. Treasury security yield rate, is almost 11 percent. The lastest figure we have available is 10.87. So, it is considerably higher than 6½, it is almost twice that.

Mr. **Schultze**. I just want to make several comments on Senator Proxmire's comments and questions.

First, with respect to the point that the participation of a large number of regional banks in international lending may reduce credit to domestic borrowers in Wisconsin and other States, I just wanted to point out that presumably business firms and their workers need not just credit but customers, and that quite clearly what happens to a very large part of the credits is that they finance export sales.

So that while it is true that there is some relationship between availability abroad and what is available here, like all good things in this world there is a balance because you can have all the credit you want and no customers and you are in pretty bad shape to employ anybody.

Second, the exporting industries—with exceptions—generally tend to be the industries that are the most productive, the ones most likely to be at the forefront of technological improvements and the like.

So, there is a balance here and it is not all one way.

Senator **Proxmire**. Now, along that line let me just say that I agree wholeheartedly that there is no question that in Milwaukee, for instance, a great many jobs depend entirely on exports. That is true of all of our cities.

However, we also have to be aware of the fact from the figures I think that Secretary Blumenthal or Secretary Fowler gave us that we face a tremendous adverse balance of trade.

And while our exports are useful, the fact is that in balance the effect of trade on American jobs is hard to see. That it is positive when we face a deficit of $50 billion, maybe $100 billlion in our trade balance. It is hard to understand how that translates into more jobs if we pursue a policy that on conditionality is going to result in reducing our exports as it reduces the imports of these LDC's.

Mr. **Schultze**. But the whole point is not to pursue a policy of conditionality that reduces exports but rather to pursue a policy of providing the credits with conditionality. That requires some adjustments but net ends up in expanding imports of LDC countries from what they would be without the credits.

Senator **Proxmire**. That may be true in some cases, but in general one of the most difficult problems of these LDC countries, the reason they are in trouble, is that they are importing too much and exporting too little. They have to cut their imports, right?

Mr. **Schultze**. That is a problem, I agree with that. My only point is, the answer is not to cut the credit off.

It is true, what you want to do is make credit available on terms which recognize reality. But if you cut credit off you are going to reduce imports a lot less than you will with conditionality.

Senator **Proxmire**. I am not talking about cutting it off, but whether we should expand it by 40, 50 percent.

Mr. **Schultze**. It depends on what you mean by expanding. There is not so much a question of increasing the annual net flow, it is a question of making sure it does not fall to zero.

This is not a question, as I understand it—although I am not that up on numbers precisely—that what is involved here is the extent to which you can keep the annual net flow going at a reasonable amount, not expanding that annual net flow.

Senator **Proxmire**. Let me ask you as a highly competent economist, Dr. Schultze, do you really believe that a drop of 3 to 5 percent in the underdeveloped countries would result in a 1½-percent drop in the growth in this country?

Does that really make any sense, does it work out that way? Would you not want to look at those numbers very carefully and also recognize the effect of an additional $9 billion of borrowing and so forth that you would have?

Mr. **Schultze**. I would agree. I would suggest that the person from whom I quoted that number will be here this afternoon and you might ask him that.

I have not gone through all the specific calculations but you must remember in international affairs, just as in domestic, there are—I use the term in a loose sense—"multiplier relationships." Forty-five percent of Japanese exports are to the LDCs; 38 percent of our own, 36 percent, something like that.

If you reduce the export growth of Germany, Japan, other countries, you reduce our own export growth. So, they do tend to cumulate. I did not work the number out myself but it seems to me it is in the ballpark. I suggest, however, you ask Mr. Krause. In fact, he may tell you I quoted him wrong but I think I am right on the number.

Could I make several other points with respect to this?

The Wall Street Journal editorial that you quoted—if I read it correctly—seemed to assume that the major debt problem in the developing countries is a series of mistakes in the past. That American lenders were patsies, were excessive in spending, and all of this.

Well, undoubtedly there were some big mistakes, probably. But let me note that in fact the LDCs as a whole did rather well in making some painful adjustments. I commend to you the Federal Reserve Bank of New York's analysis—it is a little out of date in the sense that it is 3 months old, "Autumn 1982 Quarterly Review Analysis of Bank Lending to Developing Countries."

It points out that it is a percentage of their exports. "Despite the OPEC shock, the LDCs as a whole by 1982 on their estimates will have their deficits relative to their exports back in line to just where they were in the 1967-78 period."

Now, maybe that is a little too much but it is not way out of line.

They have taken some painful adjustments. Some have done better than others. So, it is a problem of recession in the world, of falling commodity prices and partly excessive debt creation. But it is much more the first two than the third.

Next; to the extent that the problem of having made mistakes does exist and it does, it seems to me that the answer to this is to put something in place to help us in the future, not to cut off our own exports, to get ourselves in serious financial trouble because of the domino effects of dealing with this.

Now, we do need to make a balance, I realize that. But I wanted to bring out some of the counterbalancing points in response to that editorial which seems to assume it was all mistakes. What really happened, it is a major problem of the world economy.

Senator **Proxmire**. Secretary Blumenthal, a Washington Post editorial said recently that IMF needed more resources, they support that.

But they also said that:

> It is entirely true that commercial banks have made spectacularly unwise loans to the Latins, pushing the money out in a crescendo of blind, competitive zeal with little concern for recipients' deteriorating ability to pay.

Secretary Fowler suggested some reforms that we could make and I asked whether or not those reforms could not be the condition on which we would go ahead with the $8 or $9 billion as far as we are concerned, a 40- to 50-percent increase in the capability of the International Monetary Fund.

Let me ask you, what regulatory mechanisms should be used to guard against those practices in the future? Let me be specific, by the Federal Reserve, in the first place.

Mr. **Blumenthal**. Let me say first that I have no doubt that some of the developing countries who were the recipients of these loans perhaps did borrow imprudently or lived beyond their means, or pushed their development programs too rapidly.

I am sure that there have been instances of imprudent lending by banks in the past. I think I would agree that the reforms, so that we learn from this experience really, first of all, are complex. But there is a question of timing.

At this point I think the important thing is to make sure that there is not an unraveling because of the interrelationship of the domestic and the international economies.

I think it is also important to note that the problem the banks got into was one of a general worldwide recession and a liquidity crisis worldwide which probably was beyond their means to correctly identify and predict.

I think that the various suggestions Secretary Fowler has laid out in his testimony in great detail would incorporate the kinds of reforms that we ought to look at.

Senator **Proxmire**. Let me be a little more specific than Secretary Fowler and ask you, for instance, should there be a statutory limit on the amount of loans within a particular country similar to the limits, lending limits, to a single borrower?

Mr. BLUMENTHAL. I am not a banker and I am not really competent to deal with all of the implications of that, Senator.

I think that may be something that ought to be going beyond the informal arrangements that exist in banks as they set lending policies. And different banks handle this differently. There may have to be some kind of statutory limit. That is something that might well be looked at.

Senator PROXMIRE. How about placing capital requirements on international lending to curtail growth, so they would not move too fast.

Mr. BLUMENTHAL. I would have to demur, I just do not know, I am just not conversant enough with the technical implications of that.

Senator PROXMIRE. How about regulating the Eurodollar market, do you think that is necessary?

Mr. BLUMENTHAL. The Eurodollar market is a worrisome factor because it is so unregulated. But how to regulate it seems to be beyond the competence of the various national entities who have at times struggled with this.

Also, it is very difficult to get our European friends to go along with that, as I understand it.

Senator PROXMIRE. Do you have any feeling that if we go along with this without any conditions, just go ahead and provide that we are after all by far the biggest provider for the IMF if we go ahead with it that we would be encouraging lax lending practices by banks?

Mr. BLUMENTHAL. I think at this point the single most important and highest priority is to maintain the flow of resources to the developing countries in order to obviate the risk of an unraveling.

When the situation has stabilized, I think we need to look at certain kinds of reforms so that the situation cannot recur. I think the risk of unraveling is much greater at the moment than the risk of providing additional resources leading us to lax policies.

I think the banks are sufficiently sensitized to do only what is necessary in order to keep the funds flowing at this point. We had better get past this point before we look at the reforms.

Senator MATHIAS. If I could interrupt. Senator Proxmire suggested some additional regulatory steps that might be imposed on the practices.

Now, Mr. Schultze advised against draconian measures. Would you include those kinds of suggestions among draconian measures?

Mr. SCHULTZE. First, that is not what I had in mind when I coined the term "draconian."

Second, I hesitate to discuss in any detail at all the problem of bank regulating. I will venture a guess, I underline the word "guess" from just casual reading of the journals and the papers that one of the problems is international cooperation in getting relatively decent bank regulation standards. There is always a problem that somebody wants to edge out a little bit, just as they do with export credits, to get ahead of everybody else. So, it is a very difficult problem of negotiation. My guess is, it is very hard to do solely unilaterally.

Having said that, I have pretty well exhausted my knowledge of the specifics.

Senator MATHIAS. Senator Proxmire said the United States is the biggest provider of funds for the IMF, and that is a statement beyond challenge.

But I am wondering if any member of the panal could tell us who is the biggest user of funds from the IMF.

Mr. FOWLER. Who is the biggest borrower?

Senator MATHIAS. Yes.

Mr. SCHULTZE. That varies all the time.

Mr. FOWLER. That varies. We, at one point, I think it was in 1978, borrowed $3½ billion, something of that sort; did we not?

Senator MATHIAS. I believe, as you say, of course it varies. But at the current time we are not only the biggest provider but we are historically the second biggest user. I think Great Britain is ahead of us.

Senator Proxmire, you had another question.

Mr. FOWLER. I would like, before you leave this subject, to say to Senator Proxmire that I think he and I are on exactly the same wavelength.

I cannot respond to your bill of particulars about the methods because I have never been a bank supervisor. I have never been in the regulatory aspect of the banking business, the commercial banking business particularly. So, I cannot be responsive to your particular items.

You and I are on the same wavelength insofar as taking advantage of this past experience to learn whether there have been mistakes, what those mistakes were, and how to prevent them in the future.

But to negotiate it at this particular time, I would have to go along with my colleagues here and say that I think while we are dealing with the problem it is timely to have the various authorities to try and identify those areas of mistakes and what could be done to prevent them in the future. I think the negotiation of a coordinated arrangement between the various major countries at this particular juncture is putting on too much of a load and getting us away from the main current problem.

Senator PROXMIRE. You see, the problem I have is that I think the situation now provides a very strong incentive for big American banks to make these loans because I think they feel that they are virtually risk free. That there is going to be a bailout coming from some area no matter how bad the loans are, and that there is less pressure, therefore, on the private banks for making the same kinds of conditions that they would make to a private borrower as they make to these countries.

There was a fascinating story on the front page of the financial section of the New York Times this morning that banks gained by Latin debt.

It pointed out that the fees that the banks charged—they are going to charge $300 million in fees primarily to Mexico, but also to Argentina, Brazil, and Costa Rica. And that those go right up front as profits and put them in a very strong position.

At the end of the story they point out that the borrowing countries are very unhappy about it but there is nothing they can do because they are in a position where they either pay those fees or they have their borrowing cut off. As one borrower says, they could not borrow money for another 50 years if they did not do what they are required to do.

So, it looks as if this is a situation that is, if not rigged—and I am sure there is not deliberate conspiracy of any kind—but it has developed in such a way that it is to the overwhelming benefit if these banks give priorities to these loans and, it seems to me, we are aiding and abetting that.

Mr. FOWLER. The underlying premise—I have tried not to pass by on the other side of the road and not recognize what you are concerned about. You will note, on page 17 of my statement,

> The relatively unregulated character of the international lending banking units and affiliates in the Eurocurrency and offshore capital markets has resulted in the absence of public restraint on the lending.
>
> This condition was coupled with sharp competition for profit potential from fees in arranging syndicated bank loans and charging interest at floating rates geared to be well in excess of interest paid on deposits of bank borrowings. As a result, there could—

I do not say "would" because I do not know that much about it—

> * * * there could have been something less than a "hard-eyed" banking discipline on the lending side.
>
> Syndicating the arranged loans to a number of lenders and diversification of risk by international lending to a number of borrowing countries was thought to be an insulation from all but an international financial collapse which the public authorities, national and international, would seek to avoid.
>
> In any event, the situation was ripe for some financial difficulty when the second wave of excessive inflation, followed by new oil price explosions in 1979, brought on a second period of recession of "stagflation" in the developed industrial countries.

Senator PROXMIRE. Secretary Fowler, I want to congratulate you on that, that is an excellent statement. But I think it also suggests that we might want to press that before we go ahead with refurbishing the IMF. We want to throw in our leverage before we do it.

Secretary Blumenthal, you want to comment?

Mr. BLUMENTHAL. I cannot resist, Senator Proxmire, I do serve on the board of a major U.S. commercial bank.

While I am not in the management of that bank, I do sit in board meetings every month. And your characterization, or rather your suspicion that there is still an exuberant spirit on the part of management of the bank when it comes to the opportunity of lending to Mexico, Brazil, or Argentina or similar countries on the theory that this after all is risk free and highly profitable, really is not in accord with the facts.

My impression in watching this is that it is a deeply discussed problem and seen as a problem and as an element of risk. It is very worrisome to the responsible officials. I think they lose some sleep over it—as well they should.

But I think what is uppermost in their minds—as again I think it should be—is that at this point it is important to keep the ball rolling; not to keep from these countries the necessary resources so that these defaults do not occur. That would have a very serious effect on the entire banking system.

So, I think we are all in favor of looking at reforms and seeing what tightening needs to be done, what particular rules—which I am not qualified to speak to—should be considered. But I think it is a question of timing as to when and how that occurs.

Senator **Proxmire**. It is good to hear about that sleepless misery, it makes me feel much better. [Laughter.]

One other question. What benefit to the global economy as a Western democracy do we derive by providing billions of dollars of credit to Eastern Europe and the Soviet Union?

Is the global economy more vulnerable today because of the large volume of commercial bank lending to Communist countries in the seventies?

Mr. **Fowler**. Mr. Chairman, I can give you my quick answer to that. You will note in my statement, I specifically take myself out of that by saying,

> My comments will be confined to the international and financial situation in the Free World economy, omitting somewhat similar problems in the Soviet bloc. Analysis, conclusions, and recommendations in that matter involve predominantly political and security considerations of our foreign policy, quite distinctive from our international economic and financial relations with allied and friendly nations loosely constituting the Free World economy.

In other words, I think they are two entirely separate questions and I for one have been somewhat gravely concerned as a citizen over the extent of this as a political matter and as a security matter.

Senator **Proxmire**. I realize that, but we are talking about the IMF. Are not Hungary and Romania members?

Mr. **Fowler**. Yes; where they are member countries, then I think they have taken on certain responsibilities and certain obligations under the original articles of agreement of the IMF Charter, and I do not think they should be discriminated against for political reasons.

But this wholesale lending to the Soviet bloc from the private international banking system represents, I think, an entirely different problem.

Mr. **Blumenthal**. I would just like to add to that. I agree with that. I think that whole range of issues is as much political as it is economic.

I have not really understood whether it makes sense, I really question whether it makes sense that individual banks, without some kind of direction, engage in these kinds of loans because it is, in the end, a political problem.

I think on balance it is clearly advantageous to have some of these countries members of the international institutions and thus, to draw them into the international system and to have them live by the rules of that system. I think that is of some advantage.

Again, in Europe when you look at countries like Poland and others, there are complex political questions involved because of the relationship of Poland to Germany, to Central Europe, and to the trade relationships there.

Senator **Proxmire**. But the benefit to the United States is from a more peaceful and more cooperative feeling on the part of these?

Mr. **Blumenthal**. It could be, if it is properly handled. What I am questioning is the unregulated open—and in some instances excessive in my judgment—lending on the part of commercial banks to some of those countries, I think that has taken place without any particular reference to the U.S. national interest. I think that is a separate matter that ought to be looked at.

Senator PROXMIRE. Mr. Schultze?

Mr. SCHULTZE. I do not have anything to add to that. One comment, it is again my very general—not terribly well researched—impression that one of the problems has been the willingness of a few of our allies—I am thinking of one in particular—to provide subsidized credits. Then setting up very difficult competitive pressures because whatever we do does not mean that the goods will not get sold, somebody else will do it.

This is very heavily political and at the very highest level political competition that cannot be handled soleiy by changing the rules of commerical banking.

Senator MATHIAS. Gentlemen, you have all in some degree or another advocated some additional international arrangements for the future.

As you look at IMF operations, they deal and are intended to deal with balance-of-payments problems which are generally short term.

The World Bank is designed to deal with development problems which are long term.

But there is an area between these two fields of operation in which the World Bank from one side and the IMF from the other tends to be sucked, or at least is sometimes pushed.

Do you see this as a real gap and should this be an organizational area that needs to be covered?

Mr. FOWLER. Mr. Chairman, I will take first crack at that. I think there is a gap. I think there should be a rather constant and persistent reexamination of the role of the IMF in dealing with problems that involve and are very much related to its original mission, but represent a kind of distinct area of involvement.

I think in dealing with this international debt problem which does involve balance-of-payments disequilibria for the debtor countries involved and a failure on their part to adequately make the adjustments that have been necessary as a result of the inflation or price explosion, that you are seeing the International Monetary Fund evolve into a somewhat different but substantially related function to its original mission. And that is the preservation of international financial stability.

I think this is a process. We often talk about whether there should be a World Central Bank and what the attributes of a World Central Bank should be, and to what extent the IMF should be moved by the agreement of the members in that particular direction.

I think the first amendment of the articles of agreement of the IMF to provide for the issuance of special drawing rights was a step in the direction of broadening its function.

I think we are seeing another step. And if you will examine part III of my statement, I tried to focus on four or five changes which have occurred.

> The characteristics of the 1970's which should be noted in charting any strategy for dealing with the international economic and financial problem of combining economic recovery with reasonable price stability.

And there I set forth five changes, characteristics, of the international economy. I think they suggest, just by the reading of them, something of a broader function for the IMF than it has currently had, during the period of the seventies.

So, I do think—to answer your question—there is a gap and that we should be constantly exploring to what extent change and adaptation, enlargement if you will, of the function of the IMF would be appropriate.

Senator MATHIAS. Pursuing Senator Proxmire's philosophy that while there is a need to concentrate on the IMF, this is the time to do it.

As my father, who was a lawyer, used to say, "You always want to pursue a settlement while the tears are hot."

Mr. FOWLER. I once submitted something of a statement along these general lines back some years ago, and it did not get much attention at that time because we are in a state of fairly pleasant recovery.

Senator MATHIAS. The tears are hotter now. [Laughter.]

Mr. BLUMENTHAL. I would merely like to add, Mr. Chairman, that I agree with what Secretary Fowler has said. I think that is something that needs to be examined and perhaps the time is right to push that along. There is a gap there that, if we learn from this experience, might well be filled.

I think there is a related issue which we have not focused on, and that is that in order to get us out of the present situation, and even to speed the process of getting these countries back on a more stable growth path, I think, it would be very desirable if the World Bank, in a more coordinated way than has been true in the past, would work with some of the countries and really have the resources to increase its development lending by something like 50 percent over the next several years.

I think the coordination that presently exists between the Bank and the Fund on these matters could be tightened and could be improved.

Mr. SCHULTZE. Could I just add my bit to this? It seems to me there is one very special, very important, very difficult characteristic of the current situation and the outlook that is relevant for your question.

In the past, a recession in the OECD countries meant usually a pretty quick and temporary interruption in the markets for the goods of the developing countries so that, in addition to everything else, what the IMF was dealing with in the balance-of-payments problems when it was not dealing with countries' internal problems, was relatively short interruptions.

We are now, with the best will in the world and with the best policies, I think, looking at a period in which it is going to be 3, 4, 5 years or more before the developing countries get back on their old growth trend—if they ever do—on their old path.

Therefore, you have something between the kind of thing the IMF handles and what the World Bank handles. I do not have any special institutional recommendations except to endorse heartily what Secretary Blumenthal just said:

First, it is not just the IMF whose resources we have to look to, it is the World Bank, and the United States is more center than most in this area.

Second, the coordination between the IMF and the World Bank, it seems to me, is particularly important because their functions in this kind of a world in which it is neither very long-term development nor very short-term business cycle, that needs to be coordinated. I do not know what the mechanics are but it seems to me very important that that be pressed and pushed.

Senator **Mathias**. One final brief question. Each of you has referred during the course of the morning to the impact of energy prices on getting us where we are.

Perhaps my question will assume that we have the ability to influence energy prices, and we have not shown much success in that effort up to date.

But assuming that we could adopt a policy which would at least reflect where we would like to see energy prices go, what should it be? Because if oil prices, for example, continue to go down it will be good for Brazil which is an importer nation and for some other countries. It could be disastrous for Mexico, and for Nigeria, and other exporting nations.

What should our national policy be with respect to real energy prices in the world?

Mr. **Fowler**. Mr. Chairman, my quick and not very thoughtful answer to it is that as long as a cartel exists of the nature, and character, and limited makeup we should expend a good deal of energy and effort to make ourselves and much of the Free World in terms of energy not subject to the whim of a cartel.

And therefore we should go forward with the development of indigenous and other sources of supply, and the other measures which have been developed during the seventies, in establishing a greater degree of—let me put it this way, a lesser degree of dependence on a cartelized group in the energy industry.

Senator **Mathias**. Mr. Schultze?

Mr. **Schultze**. Since I think a large part of the problem of the world today—not by any means all of it but a large part—does stem from both the inflationary and the employment—depressing impacts of the big jump in oil prices, it seems to me that lower oil prices, crumbling of OPEC which could bring oil prices down substantially, is in the United States best interest and the best interest of the world.

That means you then have to do two things:

First, buy like mad for our strategic petroleum reserve, and then it is easier to do so and makes a lot of sense to do so.

Second, we would clearly have to make some very special credit arrangements—we ought to, we could afford to better than now—for those countries which, like Mexico and Nigeria, are heavily dependent on oil.

But net, it seems to me, is in our best interest mainly because I think if the price goes down that it is not going to go bouncing right back up again except in a real political crisis, and that is why you buy strategic petroleum reserves.

Mr. **Blumenthal**. I would fully agree with that. I think on balance it is very much in our interest and in everybody's interest to develop additional alternate sources of energy and to increase the total supply of energy available.

If that results in a reduction in the cost of energy, I think that is to everybody's benefit. I think there are ways of taking into account the specific problems this creates for those few countries who depend heavily on energy exports. But to do otherwise, I think, would be very counterproductive.

Senator MATHIAS. Gentlemen, you have all been very helpful. I am personally very grateful to you for being here and I am sure that all the Members of the Congress who will review this record will find it extremely helpful in the days ahead. Thank you very much.

The committee will stand in recess until 2 o'clock

[Whereupon, at 12:35 p.m., the committee adjourned, to reconvene at 2 p.m., the same day.]

AFTERNOON SESSION

The subcommittee met, pursuant to recess, at 2 p.m., in room SD-419 (4221 DSOB), Hon. Charles McC. Mathias, Jr. (chairman of the subcommittee) presiding.

Present: Senator Mathias.

Also present: Senator Proxmire.

Senator MATHIAS. The subcommittee will come to order.

This afternoon we are continuing our series of hearings on stresses and strains in the international financial system.

This morning we heard testimony on the state of the world economy. This afternoon, I hope, we can focus more narrowly on how the depressed world economy has affected the developing countries and what this in turn means for us in the United States. What the problems in the developing world will mean in terms of problems on Main Street America.

I would like to welcome to the subcommittee three distinguished witnesses for this afternoon:

John Sewell, president of the Overseas Development Council, an organization which has conducted many studies of the development process and recently has paid particular attention to the relationship between the U.S. economy and that of the Third World. Larry Krause is a senior fellow at the Brookings Institution. He is a well-known scholar in the field of international economics. And John Mellor, who is executive director of the International Food Policy Research Institute, one of several international agricultural research centers which has played a key role in helping developing countries to improve agricultural production.

It has been almost a tradition for American administrations to urge Third World countries to take a more market-oriented approach to development. The United States has urged a reduction in tariff barriers, stimulation of exports, and open capital markets.

Some of the countries with the best growth records have followed our advice, they did those things. And now, some of these same countries are facing very large debts, very low prices, verly low demand for their exports, and adjustment programs which will sharply reduce economic growth.

So, the witnesses, I hope, will discuss with the subcommittee whether our advice to the developing countries has been appropriate; the seriousness of the economic problems existing in the Third

World, and an appropriate strategy for those countries to follow in the future.

I would also hope that the witnesses might address what kind of impact U.S. domestic economic policies have on the developing countries and what kind of impact their economic misfortunes might have on the U.S. economy.

So, with those few preliminary words, we will go right to our panel. Mr. Krause is first on our list.

STATEMENT OF LAWRENCE B. KRAUSE, SENIOR FELLOW, THE BROOKINGS INSTITUTION, WASHINGTON, D.C.

Mr. **Krause**. Thank you very much, Senator, I appreciate the opportunity to appear before you this afternoon. I will read a reduced version of my paper which is presented to you for inclusion in the record.

Senator **Mathias**. Let me say at this point that all of the statements will be included in full in the record. So you can feel free to summarize.

Mr. **Krause**. The world economy is at a critical juncture. Either a recovery will begin rather shortly—and I think this is most likely—or economic conditions could worsen very considerably during 1983.

The world crisis has two dimensions, an economic dimension that arises from the extended recession in industrial countries, and a financial dimension that comes from the overhang of external debts on Eastern Europe and developing countries.

A great deal more is at stake than the economic suffering of millions of workers who have lost their jobs, although unemployment, bankruptcy, and economic dislocations are all very serious. In addition the world crisis is leading to political unrest and a weakening of institutions. This gets reflected in a churning of political leadership through elections in which the ins are voted out, and a weakening of commercial ties as, for instance, within the European Community.

Furthermore, cooperation among governments has been undermined. Without question, the gas pipeline dispute would have been much easier to resolve if the economic backdrop had been one of prosperity rather than prolonged recession.

Finally, serious challenges are now being raised in both developed and developing countries to the continuation of an open economy. I take this to be a very serious matter for the United States.

Interdependence in the world works in both directions. It spreads prosperity when the world economy is expanding, and it spreads recession when the world economy is contracting.

The severity of the world recession was not foreseen by LDC borrowers, which is another reason why their external debts rose so sharply during the last 2 to 3 years and is the principal reason why they have become so burdensome to service now.

Most observers expected the recession following the second oil price rise in 1979–80 to be much like the one following the first rise in 1973–74. Instead, it has been much more severe because inflation was worse and impossible for governments to ignore.

Along with the long recession, interest rates have remained very high in real terms. International trade has contracted for 2 years, and raw material prices have fallen sharply—in part as a result of the strong U.S. dollar.

In order to evaluate the consequences of current circumstances on the developing countries and their future prospects, it is useful to bring attention to the factors promoting their growth. Both internal and external factors are important, but let me focus on the external factors.

The external factor that is most important in promoting growth of developing countries is expansion of the world economy. When industrial countries expand, the spillover to the developing countries through trade of goods and services and through private capital flows, including direct investment, is very great.

The volume of international trade is the most important element. If industrial countries grow at about a 4-percent rate or above, their growth of imports is about twice that rate or 8 percent or more.

Since the share of the market supplied by developing countries has been rising, export volume of developing countries would be expected to rise between 12 percent and 17 percent under these circumstances. Three years of growth at these rates would do wonders to solve the problems of the developing countries. However, if industrial countries grow by only 2½ to 3 percent, their import growth is only directly proportional and thus exports by developing countries would be much less.

Furthermore, if industrial countries have very little growth—say less than 1 percent—their imports contract, with a devastating effect on developing country exports.

A second element relates to the prices that the developing countries receive for their exports, and a distinction must be drawn between manufactured goods and raw materials.

Approximately 20 percent of the exports from developing countries are manufactures, and these have been particularly fast growing. The prices for these exports rise in line with those of manufactures in advanced countries. In 1982, the price of these goods—measured in dollars—declined about 3 to 4 percent.

With economic recovery and some depreciation of the dollar, these goods should rise in price about 6 percent a year. The prices of raw materials, however, are much more volatile. They peaked in October and November of 1980 and declined 38 percent until the end of 1982, about a 12-percent decline on average during 1982.

With the world recovery, the prices of these goods should rise more sharply, but it greatly depends on the strength of the world recovery.

Thus, if there is a long-lasting world economic upswing, the value of exports of developing countries could rise 20 to 30 percent per year—the higher figure for countries selling manufactured goods. A continuation of a stagnant world economy, however, would imply a further decline in the value of these countries' exports, possibly about 10 percent per year.

Thus, the difference between the debt problem becoming manageable, and it becoming intolerable, is recovery in the world economy.

Of course, the situation in the developing countries could be made worse if the advanced countries should raise protectionist barriers against their exports. Rapid growth of developing countries in some measure depends on a congenial world market. This not only requires growth, but also a willingness to permit the developing countries to export those products in which they achieve a comparative advantage.

Finally, international financial markets must provide adequate credit to permit the developing countries to finance their necessary balance-of-payments deficits. Under normal times, this is no problem because high real rates of return on capital in developing countries makes this lending desirable and profitable for both borrowers and lenders.

However, in view of the current economic crisis, the financial mechanism needs attention by governments to make it operate properly.

The most likely world economic outlook is that recovery will begin in the United States very shortly and strengthen in the second half of 1983. Japan is likely to have a very weak year for them, but still manage to grow between 2 and 3 percent. In Europe, however, the recession may not have hit bottom yet and a recovery is not expected until the latter part of 1983 or 1984.

Thus, industrial country growth during 1983 might average about 2 percent but might be getting stronger as the year progresses. This means that the developing countries will continue to experience weak export demand until the second half of 1983.

Finance is likely to continue to be a problem as new moneys need be borrowed and old debts repaid. However, the problem should ease by 1984.

Given the risks in the world economy, it is proper to ask what can be done to insure an improvement and try to make things better. Of all the things that the United States could do, the most important by far is a further reduction in short-term interest rates.

As you have been told ad nauseam, this requires a reduction in the out-year budget deficits to permit the Federal Reserve to ease credit. While this should be done for domestic reasons, it also will help the world economy.

Second, the United States should encourage the continuation of lending to responsible borrowers among the developing countries. This can be effectuated by reasonable behavior by our bank examiners, by bilateral arrangements between our Government and other governments, and through international institutions like the IMF. Thus, the IMF must be provided with adequate resources to continue lending.

In the medium term, some institutional changes are required in bank lending to developing countries to prevent a recurrence of today's problem. But these reforms are moderate ones and should not stand in the way of continued lending now.

Finally, the United States should do everything it can to maintain an open trading system. We should resist protectionist pressures at home and discourage them abroad. Over the next few years, the developing countries should be integrated into the GATT system with both rights and responsibilities. We should now be studying ways to bring that about.

Thank you very much, sir.
[Mr. Krause's prepared statement and attachment follows:]

PREPARED STATEMENT OF LAWRENCE B. KRAUSE [1]

CRISIS IN THE WORLD ECONOMY

The world economy is at a critical juncture. Either a recovery will begin rather shortly—and I think this is most likely—or economic conditions could worsen very considerably during 1983. The world crisis has two dimensions; an economic dimension that arises from the extended recession in industrial countries and a financial dimension that comes from the overhang of external debts on Eastern European and developing countries. There are short term and medium term elements in both dimensions. A great deal more is at stake than just the economic suffering of millions of workers who have lost their jobs, although unemployment, bankruptcy, and economic dislocations are all very serious. In addition, the world crisis is leading to political unrest and a weakening of institutions. This gets reflected in a churning of political leadership through elections in which the "ins" are voted "out" and a weakening of commercial ties, as for instance, within the European Community. Furthermore, cooperation among governments has been undermined. Without question, the gas pipeline dispute would have been much easier to resolve if the economic backdrop had been one of prosperity rather than prolonged recession. Finally serious challenges are now being raised in both developed and developing countries to the continuation of an open world economy. I take this to be a very serious matter for the United States.

During most of the postwar period, efforts have been made to open the world economy and the economic growth and welfare of countries was thereby enhanced. The term interdependence became commonplace in describing the situation. The advantages were demonstrated by the advanced countries and were subsequently emulated by several developing countries. Indeed, it was the adoption of outward oriented policies that led several developing countries such as Brazil and South Korea into large external debts. The outward policies increased their exports and economic growth which made them creditworthy and also raised the internal profit rate on invested capital which encouraged them to borrow. The outward strategy yielded very rapid economic growth for these countries that adopted it, indeed growth rates were achieved much above those of advanced countries.

However, interdependence works in both directions; it spreads prosperity when the world economy is expanding and it spreads recession when the world economy is contracting. The severity of the world recession was not forseen by LDC borrowers (and few others as well), which is another major reason why their external debts rose so sharply during the last two to three years and is the principal reason why they have become so burdensome to service. Most observers expected the recession following the second oil price rise in 1979-80 to be much like the one following the first rise in 1973-74. Instead it has been much more severe because inflation was worse and impossible for governments to ignore. Along with the long recession, interest rates have remained very high in real terms, international trade has contracted for two years (10 percent in 1982), and raw material prices have fallen sharply (about 38 percent on average) in part as a result of the strong U.S. dollar.

FACTORS PROMOTING GROWTH IN DEVELOPING COUNTRIES

In order to evaluate the consequences of current circumstances on the developing countries and their future prospects, it is useful to bring attention to the factors promoting their growth. Both internal and external factors are important. Internally, the characteristics that seem to differentiate those developing countries that have made rapid strides in recent years from those that have not are a political commitment to promote growth, stability of institutions, market oriented economic policy, and capability to adjust in product, labor, and capital markets. Elaborating each of these factors would require more time than is available, but it should be noted that all of the large debtors among the developing countries score relatively well on these characteristics. The large debtors are also the promoters of growth. This is not to suggest that there were not instances of excessive borrowing, but in the main foreign indebtedness was undertaken within a reasonable domestic setting—that is, growth and debt go together.

---

[1] Senior Fellow in Economics at the Brookings Institution. His views should not be attributed to other staff members, officers, or trustees of the Brookings Institution.

The external factor that is most important in promoting growth of developing countries is expansion of the world economy. When industrial countries expand, the spillover to the developing countries through trade of goods and services and through private capital flows including direct investment is very great. The volume of international trade is the most important element. If industrial countries grow at about a 4 percent rate or above, their growth of imports is at about twice that rate or 8 percent or more. Since the share of the market supplied by developing countries has been rising, export volume of developing countries would be expected to rise between 12 percent and 16 percent under these circumstances. Three years of growth at these rates would do wonders to solve the problems of the developing countries. However, if industrial countries grow by only 2.5 percent to 3 percent, their import growth is only directly proportional and thus exports by developing countries would be much less. Furthermore, if industrial countries have very little growth, say less than 1 percent, their imports contract with a devastating effect on developing country exports.

A second element relates to the prices that the developing countries receive for their exports and a distinction must be drawn between manufactured goods and raw materials. Approximately 20 percent of the exports from developing countries are manufactures and these have been growing particularly fast. The prices for these exports rise in line with those of manufactures in advanced countries. In 1982 the price of these goods measured in dollars declined by about 3 percent to 4 percent. With economic recovery and some depreciation of the dollar, these goods should rise in price about 6 percent a year. The prices of raw materials are much more volatile. They peaked in October-November 1980 and declined 38 percent until the end of 1982—about a 12 percent decline on average during 1982. With a world recovery, the prices of these goods should rise more sharply, but it greatly depends on the strength of the recovery.

Thus if there is a long lasting world economic upswing, the value of exports of developing countries could rise 20 percent to 30 percent per year—the higher figure for countries selling manufactured goods. A continuation of a stagnant world economy, however, would imply a further decline in the value of these countries exports possibly about 10 percent. Thus the difference between the debt problem becoming manageable and it becoming intolerable is recovery in the world economy.

Of course the situation of the developing countries could be made worse if the advanced countries should raise protectionist barriers against their exports. Rapid growth of developing countries in some measure depends on a congenial world market. This not only requires growth, but also a willingness to permit the developing countries to export those products in which they achieve a comparative advantage.

Finally, international financial markets must provide adequate credit to permit the developing countries to finance their necessary balance of payments deficits. Under normal times there is no problem because high real rates of return on capital in developing countries makes this lending desirable and profitable for both borrowers and lenders. However, in view of the current economic crisis, the financial mechanism needs attention by governments to make sure it operates properly.

OUTLOOK FOR THE DEVELOPING COUNTRIES

The most likely world economic outlook is that recovery will begin in the United States very shortly and strengthen in the second half of 1982. Japan is likely to have a very weak year for them, but still manage to grow between 2 and 3 percent. In Europe, however, the recession may not have hit bottom yet and a recovery is not expected until the latter part of 1983 or 1984. Thus industrial country growth during 1983 might average about 2 percent, but might be getting stronger as the year progresses.

This means that the developing countries will continue to experience weak export demand until the second half of 1983. Finance is likely to continue to be a problem as new monies need be borrowed and old debts repaid. However the problem should ease by 1984.

Individual developing countries will progress at differing rates. Mexico, for instance, will benefit from the recovery in the United States and the competitive improvement which the devalued peso will give them. However, they will be hurt by some erosion of oil prices, but not seriously unless the price should collapse.

The area with the best economic performance is again likely to be the Pacific basin. The countries in the Pacific will gain from the U.S. recovery and the continued growth of Japan.

Latin American countries are likely to achieve some financial recovery in 1983, but not much growth of income. Many of these countries have heavy debts which must be attended to first before rapid growth returns.

The African countries are likely to suffer another year of relative stagnation. First, they are more dependent on slower growing raw materials than other areas and on markets in Europe which will not be very robust.

POLICY ISSUES

Given the risks in the world economy, it is proper to ask what can be done to help ensure an improvement and to try to make things better. Of all the things that the United States could do, the most important by far is a further reduction in short term interest rates. As you have been told ad nauseam, this requires a reduction in the out-year budget deficits to permit the Federal Reserve to ease credit. While this should be done for domestic reasons, it also will help the world economy.

Second, the United States should encourage the continuation of lending to responsible borrowers among the developing countries. This can be effectuated by reasonable behavior by our bank examiners, by bilateral arrangements between our government and other governments, and through international institutions like the IMF. Thus the IMF must be provided with adequate resources to continue lending. In the medium term, some institutional changes are required in bank lending to developing countries to prevent a recurrence of today's problem, but these reforms are moderate ones and should not stand in the way of continued lending now.

Finally the United States should do everything it can to maintain an open trading system. We should resist protectionist pressures at home and discourage them abroad. Over the next few years the developing countries should be integrated into the GATT system with both rights and responsibilities. We should now be studying ways to bring that about.

Economic Research

Goldman Sachs

November 3, 1982

International Economic Comment

EXTERNAL DEBT OF DEVELOPING COUNTRIES AND THE WORLD ECONOMY

Summary and Conclusions

The difficulty that several developing countries (LDCs) have experienced in servicing foreign debts to commercial banks has caused a crisis in bank lending to them. Developing countries had $327 billion in debts to commerical banks as of December 31, 1981, of which 49% was due to mature in one year. The seven largest debtors accounted for 61% of the total (see Table 1). If banks are unwilling to roll over maturing debt, a calamity will be forced on the world economy. Even if this unlikely event is avoided, a failure to increase loans to LDCs to finance the existing balance-of-payments deficits on current account would be serious. Their real growth would be reduced about 3%, world trade would contract more than $50 billion, and even the United States would lose 1.5% of its GNP.

The ability of developing countries to service foreign debt rests most fundamentally on their success in exporting goods and services. The world recession has reduced LDC exports because of a slight reduction in volume and a 35% reduction in prices (measured in dollars). An economic recovery in the United States would stop the decline of volume and price, but an increase depends on a broader economic recovery in industrial countries that is unlikely before the second half of 1983. In the meantime, bank financing with the help of the IMF is necessary to prevent a world economic contraction.

The most optimistic development is the decline in interest rates. LIBOR averaged 16.5% in 1981 and could drop to 11%-12% in the next 12 months. This would save $7.5 billion for the seven major borrowers. A further ebbing of interest rates in the United States would calm international financial markets even more.

This material is for your private information, and we are not soliciting any action based upon it. Opinions expressed are our present opinions only. The material is based upon information which we consider reliable, but we do not represent that it is accurate or complete and it should not be relied upon as such.

Table 1

BIS Reporting Banks' Claims on and Liabilities to Developing Countries, December 31, 1981
(billions)

				As a % of Exports of Goods and Services		
Country	Liabilities to	Claims on	Net	Claims	Interest and Principal Due in 1982(a)	Interest
Mexico	$12.4	$ 56.9	$ 44.5	189%	129%	37%
Brazil	5.2	52.7	47.5	196	122	45
Venezuela	19.7	26.2	6.5	107	95	14
Argentina	6.7	24.8	18.1	210	179	44
Korea	3.6	19.9	16.3	72	53	11
Chile	4.1	10.5	6.4	172	116	40
Philippines	3.6	10.2	6.6	123	91	18
Total	$55.3	$201.4	$146.1	149	145	39
All developing countries	$261.9	$327.0	$65.1	83	NA	NA

(a)Morgan Guaranty Trust Company.

NA - Not available.

Source: Bank for International Settlements (BIS), July 1982 International Financial Statistics, IMF, October 1982.

Ultimately, structural changes, including a larger role for the IMF, will be required to prevent a recurrence of the problem. However, the United States has a particular and possibly unique responsibility to prevent the current crisis from ending in calamity. This means that the Fed must be conscious of the downside risk in exercising its authority, and the Administration must make budgetary decisions that support responsive monetary policy.

Introduction

The publicized difficulties of countries such as Poland, Romania, Cuba, Argentina, and Mexico in meeting their current obligations to foreign commerical banks have called into question the stability of world financial markets. Nevertheless, as recently as October 1981, the OECD remarked that "the current debt of the Third World gives room for neither complacency nor alarm."* This rather sanguine view was noted with approval by an IMF official dealing with external debt problems shortly thereafter.** Has the situation changed radically in one year? And what are the implications for the world economy?

Several important changes have in fact taken place in 1982. As of June 1981, about 30 developing countries were in arrears in payments to commercial banks, but these accounted for only 5.5% of total bank claims on developing countries, though individual banks had significant exposure to other problem areas such as Poland. However, the addition of Argentina and Mexico changed the picture considerably. At the end of 1981, more than half of the bank claims on developing countries (including OPEC) were concentrated in seven countries (Table 1) and amounted to $201 billion. If several of these large countries stopped servicing their loans, the problem would become much more serious.

The ability of these countries to continue to service external debts depends on their success in exporting goods and services. Failure would require the entire adjustment to be made up through reductions in imports, which would impose a politically unacceptable burden. Orderly serving also depends on continued access to new bank credits. If commercial banks in the aggregate rapidly decrease their exposure to these countries, this would also place impossible burdens on the borrowers.

A major disruption in international financial markets would be calamitous for both borrowing and lending countries. If borrowers were driven into formal default, they would be completely isolated from world markets of all kinds since any asset found abroad would be attached by creditors. Also, if commercial banks were forced to write off foreign loans because of default, many major banks would find most of their capital undermined, and several bankruptcies would probably occur. These consequences are so drastic and well-known that the extreme scenario is very unlikely. However, the impact of a less severe disturbance is important enough to merit examination.

---

*OECD, External Debt of Developing Countries, Paris, 1981.

**Nicholas C. Hope, "Financial Development in the 1980s," Unpublished.

Disquieting Warning Signs

A 1980 study by the IMF staff, of six countries that sought multilateral reschedulings from banks during the last half of the 1970s, showed that bank lending had expanded very rapidly to each over a short period, then declined precipitously when the possibility of debt servicing difficulties became apparent.* Therefore, it is noteworthy that bank lending to non-oil developing countries increased $40 billion in 1979, $49 billion in 1980, and $50 billion in 1981, representing increases of 26.6%, 26.2%, and 22.2%, respectively (includes Mexico but not Venezuela). This growth was much faster than that of other lending by commercial banks. The share of net external claims in 14 industrial countries rose from 12.6% in 1978 to 17.4% in 1981, with a significant portion of the rise going to developing countries.

The capital market did not seem to be signaling that developing countries' debts were becoming excessive, and this may have encouraged them to borrow more. As shown in Table 2, LIBOR rose to 16.5% in 1981, from 9.4% in 1978, but this merely reflected rising interest rates in the United States. The spread that developing countries had to pay over LIBOR to obtain syndicated credits (reflects risk premiums) actually declined to 0.90% in 1981 from 1.23% in 1978, for both large and small debtors. Furthermore, the maturities of syndicated bank loans hardly changed over this period, another indication that the market was not forecasting great difficulties. Nevertheless, because of past loans, the share of bank debt of all developing countries maturing within one year rose to 49.7% at the end of 1981 from 46.3% in mid-1978. The overhang of a large amount of maturing debt increased the market's fragility by raising the ratio of gross to net borrowing requirements.

The most serious factor threatening orderly lending to developing countries is the unexpected continuation of the recession in industrial countries. Many forecasters expected a recovery to begin in late 1981 or early 1982 and yield 1982 growth rates of about 3% on average. This led the IMF to forecast world import volume growth of 4.6% in 1982, reflecting an imports-to-GNP growth elasticity of 1.6 and the fact that industrial countries accounted for 66% of world imports in 1980.** In fact, the economic recovery has been delayed, and industrial country growth in 1982 is likely to be a combination of small positive and negative figures with a negative average. As a result, the volume of international trade is likely to decline about 5%. Industrial country imports from non-oil developing countries are somewhat more responsive to income than the average (elasticity of 1.7), and thus, the export volume of many borrowing countries is likely to be down more than 5%.

---

*Discussed in IMF, Occasional Paper 14, International Capital Markets: Development and Prospects, 1982, July 1982.

**IMF, 1982 World Economic Outlook, Table 8.

Table 2

Developing Countries' Terms on Syndicated Credits, 1978-1981

	Median Values				
	Larger Debtors	Smaller Debtors	All	Average(a)	LIBOR(b)
Spreads over LIBOR					
1978	1.09%	1.60%	1.23%	1.17%	9.4%
1979	0.92	1.29	1.03	0.81	12.0
1980	0.81	1.30	0.86	0.87	14.4
1981	0.81	1.15	0.90	0.94	16.5
Maturities, years					
1978	7.5	7.0	7.0	8.9	
1979	8.4	7.6	8.0	9.0	
1980	7.6	7.4	7.6	7.9	
1981	7.8	7.0	7.4	7.6	

(a)According to the OECD, weighted-average terms on all syndicated credits to developing countries, excluding those that are members of the Organization.

(b)Six-month Eurodollar deposit rate.

Source: IMF staff calculations based on World Bank data.

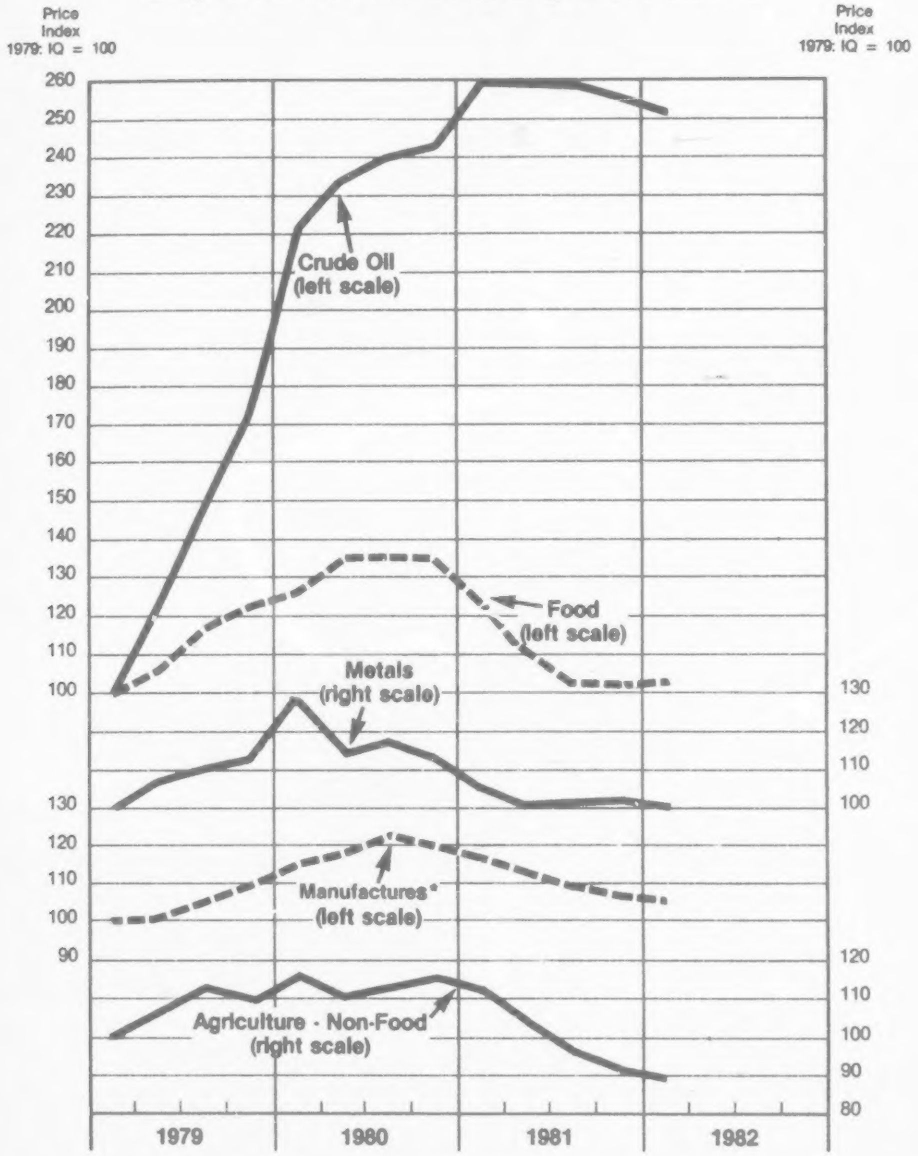
The recession in industrial countries is also having a strong impact on world commodity prices. Studies have shown that fluctations in primary commodity prices can be largely explained by movements in cyclical activity in industrial countries and the price of manufactured exports.* Other studies indicated that a rising dollar exchange rate has an independent effect in pushing down commodity prices set in dollar markets. As can be seen in Figure 1, commodity prices measured in dollars peaked during 1980 and have been declining since then. However, several categories of commodities have behaved differently. From the start of 1979, oil prices exploded upward two and a half times, then declined only moderately. Food prices rose 35%, declined 30%, and then stabilized. Non-food agricultural commodity prices rose only 15%, then declined gradually and persistently for a total drop of 23% at the end of March 1982. Metal prices moved somewhat eratically; they seem to have risen less sharply than food, or about 28%, completely reversed the rise, then stabilized.

---

*Louis M. Goreux, Compensating Financing Facility, IMF Pamphlet Series, no. 34, 1980.

FIGURE 1

Dollar Price Indexes of Exports of Developing Countries



*Manufactured Goods Exported by Developed Countries.

Source: International Monetary Fund, General Agreement on Trade and Tariffs, United Nations.

The worsened trade picture and the decline in commodity prices created a great strain for developing country borrowers in 1982. Argentina's conflict with Britain and the end of the presidential term in Mexico seriously complicated the problems. When servicing difficulties became apparent, commercial banks behaved in the usual fashion by trying to sharply reduce exposure. Though current data is unavailable, anecdotal evidence supplied by Richard S. Dale, former financial executive with N. M. Rothschild & Sons Ltd., suggests that new bank lending to Eastern Europe and Latin America has stopped, at least for the moment.* The IMF has noted a tendency toward regionalization; that is, when a developing country faces servicing difficulties, commercial banks restrict lending to other developing countries in the same region. This is in part reflected by widening LIBOR spreads, which have risen to 1.75%-2.25% for Latin American countries. Even untarnished countries like Korea have found banks unwilling to extend loan maturities as much as they desire. Richard Dale described these circumstances as a seizing-up of world financial markets.

Outlook for the Next 12 Months

Non-oil developing countries had current account deficits requiring external financing of $99 billion in 1981. Of this, $40.3 billion accrued to six countries (see Table 3; Venezuela earned a surplus in 1981). The IMF forecast a further $97.0-billion deficit in 1982 (that figure now appears somewhat high), which would require about $70 billion of net borrowing (the rest coming from transfers and direct investment), more than half from private sources. In fact, much of the new financing was arranged during the first half of 1982. However, with more than $140 billion of debt maturing within the year, a constant stream of refinancing is necessary to keep the system lubricated.

Quite a few banks in Japan (under informal guidelines from the Ministry of Finance) and smaller regional banks in the United States have been using these maturing loans to reduce their exposure. As shown in Table 1, interest (calculated at an estimated 15%) and maturing debt would absorb all of the exports of these countries if not renewed. Thus, other banks or official institutions must pick up the slack from the banks pulling out of the market.

The outlook for the next 12 months depends on the prospects for world trade and commodity prices, the willingness of commercial banks to lend, and the availability of alternative official financing. If these countries face larger deficits than they can finance, they must adjust by trimming income and reducing imports directly.

---

*Statement before the Committee on Energy and Commerce, House of Representatives, September 17, 1982.

Table 3

Foreign Trade of the Seven Largest Developing Country Borrowers

(billions)

Country	Merchandise			As a % of Exports			As a % of Imports			
	Exports (1981)	Imports (1981)	Current Account Balance of Payments (1981)	Fuels, Minerals, and Metals (1979)	Other Primary Commodities (1979)	Manufactured Goods (1979)	Food (1979)	Fuels (1979)	Other Primary Commodities (1979)	Manufactured Goods (1979)
Mexico	$19.8	$23.2	$(12.8)	39%	22%	39%	8%	2%	7%	83%
Brazil	23.3	22.1	(11.7)	11	50	39	12	37	7	44
Venezuela	19.9	12.4	4.0	98	1	1	12	1	5	82
Argentina	9.2	8.2	(4.1)	2	74	24	7	17	9	67
Korea	20.9	23.9	(4.5)	1	10	89	9	19	17	55
Chile	4.0	6.6	(4.8)	59	21	20	14	21	4	61
Philippines	5.7	7.9	(2.3)	18	47	35	7	22	6	65

Source: International Financial Statistics, IMF, October 1982 and World Development Report 1982, World Bank.

How different will the next 12 months be from the last? The United States aside, the economies of most industrial countries appear to be headed for a repeat performance. Indeed, they seem to be dependent on the stimulus of exporting to the United States to pull them out of their recessions. In the case of Canada, this can happen with a lag of only a few months. The delay between a U.S. economic pickup and renewed exports by Japan is several months longer and, for Europe, still longer. Thus, if the U.S. recovery does not begin in earnest until the first or second quarter of 1983, very little of it will filter through to other industrial countries during the next 12 months. However, a U.S. recovery alone might be enough to stem the decline in world trade volume, and therefore, a forecast of zero to a slight increase seems reasonable.

The outlook for commodity prices is not promising for the developing countries. A further decline of possibly 5%-10% seems to have taken place between the first and third quarters of 1982, reflecting weakness in all markets. Economic recovery in the United States next year should help brake further declines, including manufactures, but by itself would not imply much recovery. However, if the U.S. current account should swing into deficit because of the U.S.-led recovery, the dollar might weaken relative to some other currencies (Japanese yen and German mark), which would push some of these prices slightly upward. Obviously, factors peculiar to each commodity will also be important. What appears to be happening, however (Figure 1), is a convergence of prices (other than petroleum) as world inflationary forces ebb. A reasonable forecast for the next 12 months (including petroleum) would be no change measured in dollars.

The one major favorable factor in the outlook for borrowing countries is the decline in interest rates. Six-month Eurodollar rates declined to 12.4% at the end of August and have dropped further since then, reflecting U.S. interest rates. If LIBOR should average 11.0%-12.0% during the next 12 months, compared with 16.5% in 1981, developing country borrowers would save about $16 billion on bank debt, since these debts are primarily on a floating-rate basis. Of course, they would also earn $13 billion less on their deposits, but for the large borrowers with large net debt balances, the savings would be substantial (approximately $7-$8 billion or 18% of total interest payments). This may well be the most important price factor in the outlook.

One can only make assumptions concerning the continuation of bank credit to these countries. The most restrictive assumption consistent with system stability is that banks would roll over maturing loans but issue no new credits, which would require immediate balancing of current accounts by borrowing countries. This would necessitate a 35% reduction in merchandise imports by the major borrowers. At the other extreme would be banks' willingness to increase their net lending another 15%, or $50 billion, of which $35 billion would have to go to the major borrowers to cover current account deficits without forced retrenchment.

To convince commercial banks to increase their exposure in developing countries, the IMF must participate in lending to problem countries such as Argentina and Mexico. The Fund's participation increases the creditworthiness of countries by approving their macroeconomic programs for returning to financial stability, certifying the accurancy of data such as for foreign debt, and accepting some of the risk in providing new resources. Of course, conditions set down by the IMF must be economically possible and politically acceptable to borrowing countries, but that should not be an insuperable barrier. Thus, a more active role for the IMF seems to be necessary to keep the international financial system from contracting.

Using a link model of world trade, Morgan Guarantee Trust estimated that with just a 10% increase in bank lending, the growth rate of all non-oil LDCs would be reduced 1.5% (3% for Latin American countries). Without any increase in bank lending, the growth would be reduced 3% (5.5% for Latin America).

Impact on the World Economy

The value of world trade in 1981 was about $2,000 billion. If the discontinuance of bank credit forced a $35-$50 billion decline of imports by developing countries, approximately 1.5%-2.5% of world trade would be lost directly. However, with the multiplier effects, the total decline would be much greater and would seriously impede economic recovery in industrial countries. About 26% of OECD exports go to developing countries; however, the concentration of several industrial countries is much greater. Fully 45% of Japanese exports and 38% of U.S. exports are involved. The situation is made more difficult for the United States because nearly half of its developing country exports are to Latin America, the area most severly impacted. U.S. exports to Latin America are now running 18% below 1981, partly due to the high value of the dollar and the consequent loss of U.S. competitiveness, but also significantly due to the drying up of bank loans. If the United States should lose an additional $20 billion in merchandise export sales because of the absence of new bank credit (the proportionate U.S. share), net exports would probably decline somewhat more, and U.S. income growth would be about 1.5% less -- a remarkably large share of the expected U.S. recovery in 1983.

It should not be forgotten how important the health of the Mexican economy alone is to the United States. Nearly 8% of U.S. exports go directly to Mexico, and many U.S. companies have direct investments there. Loss of job opportunities in Mexico forces large numbers of Mexicans north to seek employment, which adds additional pressure on the unemployed in the United States. If economic weakness led to political instability, critical political and security concerns would be added. We are accustomed to hearing that Mexico cannot prosper unless the United States is prosperous, but the reverse is also becoming true.

Policy Issues for Governments

After the current crisis has passed, governments will have to consider ways to prevent a recurrence. There appears to be a structural weakness in the market where commercial banks lend to developing countries. Competition among the 15,000 banks worldwide tends to promote overlending to developing countries, and because of the flexibility of such borrowing, governments in developing countries tend to grant guarantees too liberally, which results in overborrowing. Thus, restraint is lacking on both sides. Given the tendency for this lending to contract when difficulties appear, the structural weakness adds instability to the world economy.

The solution should involve an unbiased third party to issue prudent guidelines for lending. This role could easily be filled by the IMF, involving it in preventing difficulties rather than just solving them. Also, differences in bank regulation now encourage banks to use many imprudent devices to reduce costs in foreign lending. Competition forces even careful banks to take risks they should avoid. Cooperation among bank regulators in the industrial countries could solve this problem.

However, the current crisis requires immediate attention. As already noted, the IMF will have to lend liberally over the next 12 months, and industrial countries will have to provide it with adequate financial resources. These resources cannot wait until a quota increase is approved, although that may also be necessary. Rather, a special fund such as the one proposed by the United States would be more responsive to the need. Furthermore, governments should encourage responsible lending by their commercial banks, particularly if the IMF is involved.

The United States has an especially heavy responsibilty to make sure that the current crisis in the world economy does not end in a calamity. Only the United States can engineer an economic recovery by itself, though it too is constrained by world developments. Thus, the Federal Reserve should provide sufficient finance for the economic recovery. A premature rebound in U.S. interest rates that choked off a U.S. recovery would probably bring on a world calamity and must be avoided. This downside risk must be fully appreciated by the Fed. Furthermore, the Administration should propose a responsible budget in January to ensure that a rebound of interest rates is totally unjustified. Additional moderate declines in U.S. interest rates would have a very calming effect on the world economy and should be acceptable to U.S. monetary authorities.

Lawrence B. Krause
International Economic Consultant

Senator MATHIAS. Thank you very much, Mr. Krause.
Mr. Sewell?

STATEMENT OF JOHN W. SEWELL, PRESIDENT, OVERSEAS DEVELOPMENT COUNCIL, WASHINGTON, D.C.

Mr. SEWELL. Thank you, Mr. Chairman.

I want to start off by saying that my testimony reflects my own views, not necessarily those of my colleagues or my board of governors at the Overseas Development Council. In good part, however, it reflects the analysis of the United States which will appear in the next issue of the Overseas Development Council's annual assessments of American relations with the developing countries, which will appear in early April of this year.

Senator MATHIAS. I hope you will see that we get a copy of that on this subcommittee.

Mr. SEWELL. I will indeed see that you get a copy.

I want to focus on the prospects for the Third World and to talk particularly about the impact and the importance of growth and progress in the developing countries—or lack of growth in those countries—for the United States.

The basic conclusion of my testimony is that global growth in the 1980's will not be restored just through policies designed to restore growth in the OECD countries; that, of course, is crucial as Larry Krause pointed out. But restoring global economic growth in the years ahead will be much more difficult unless the new importance of the developing countries to the United States is taken into account.

Let me spend a few minutes on that new importance that I describe in the testimony as "the emergence of the developing countries." It is by now well known that in the years since 1950, the aggregate economic growth in the developing countries has been remarkable—much faster, in fact, than the industrial world grew at any time in the 19th and early 20th century.

Even in the very troubled 1970's, the developing countries in the aggregate grew at close to 6 percent a year where the industrial countries grew at just over 3 percent a year. As a result they now account for a growing part of world gross national product and could account for as much as 25 percent of world GNP by the year 2000, according to the projections of the World Bank.

The participation of the developing countries in both the international trading system and the international financial system has expanded greatly as a result of this growth. They earned much more from trade, particularly with the industrial world, than they received from foreign aid. And there had been a little remarked upon shift in the composition of financial flows from the industrial world to the Third World.

In 1960, financial flows were dominated by foreign aid; aid was close to two-thirds of the total finances transferred between the rich and the poor countries. But by last year, that was almost totally reversed; in 1980 less than one-third of the total financial transfers between the rich and the poor countries resulted from foreign aid. The remainder, more than 70 percent, came from private transactions of a variety of kinds.

Senator MATHIAS. Of course, that is reflected in the character of the debt today.

Mr. SEWELL. Exactly.

Senator MATHIAS. Sixty-five percent of that debt is held by private banks.

Mr. SEWELL. In sum, the last decades have exhibited a rather remarkable, successful record of bringing countries into the global economy over a relatively short period of time. And the result is that they are important participants in the aggregate in the world economy and they are very important to the health and progress in the industrial countries themselves.

This is particularly marked, I must say, for what I will call for shorthand, the middle-income countries. It is some 40-odd countries, including the member of OPEC and the newly industrialized countries who really are now important participants in the world economy. Their contribution to the growth of the world economy in the last decade was larger than that provided by the United States, equal to Japan and Germany, and larger than industrial Europe, according to a recent internal OECD study. These countries are well on their way to catching up with the industrial countries. And as a result, they are now an autonomous force which influences, on a macroeconomic level, demand in the industrial world.

The implications of these developments for the United States are considerable. I focus in my statement on the implications for exports by the United States because trade is now much more important to the United States in terms of its gross national product than it was two decades ago.

The developing countries as a group now purchase 38 percent of the exports from the United States, more than are purchased by the European Community, Eastern Europe, the Soviet Union, and China combined. The growth of the exports has been very rapid. In the period since 1976, exports to the middle-income countries grew at about 21 percent a year. And the trade is essentially advantageous—to use the technical term. We export heavy machinery, chemical, and agricultural products—which of course are high-technology goods in our country—in return for lower cost consumer goods and raw materials from the developing world.

I point out on table 1—see page 92—that the growth in American exports to the developing countries has slowed rather dramatically in the recent past as the developing countries have felt increasingly pressed and as the value of the U.S. dollar has increased.

The growth in the period from 1979 to 1980 was, as you can see, about 38 percent but it dropped to 12 percent between 1980 and 1981; and if you compare the first half of 1981 with the first half of 1982, it actually becomes negative in terms of growth of U.S. exports to the developing countries. Agricultural exports for instance fell by 8 percent in 1980–81 for the first time since 1969.

I do not want to repeat what has already been said about the prospects for the developing countries, except to point out that they are not favorable. And they are not favorable for a series of reasons, including trends now occurring in the world economy. World trade is stagnant. Protectionism is on the increase, even though experts may disagree on its extent. Debt is mounting rapidly. Financial conditions in the developing countries are becoming politicized.

There is an increasing question of the ability of private markets alone to handle the financial needs in the developing countries. Commodity prices—and I remind you that the developing countries still earn close to 60 percent of their export earnings for sales of commodities—are at a 30-year low. And the projections for the growth in official development assistance show that it will grow much more slowly than the 4-percent-a-year average growth in the seventies, mainly because of poor performance by the United States. Every other industrial country has pledged to increase its level of aid, with the exception of Great Britain, and we are now the laggard. In fact, next year we will be at the bottom of the list in terms of percentage of national wealth devoted to foreign aid, having been passed by Italy this year.

I summarize in the testimony two scenarios for future development over the decade in the countries of the Third World. They are drawn from the "World Development Report" of the World Bank. They should be treated with care, as any economic projections out over a 10-year period are at best suggestive.

But they are useful in an illustrative sense because the Bank has for the last several years issued what they call a "high case" and a "low case" scenario. The differences are simple: The high, or more optimistic, case predicates the resumption of noninflationary recovery in the OECD countries, predicates no additional restrictions in the world trading system, and an adequate flow of financing for the developing countries.

It is worth looking at tables 2 and 3 of my statement because they illustrate the differentiation that now exists within the developing world. In the first place, they illustrate the importance to the middle-income countries for a favorable global economic climate. If there is adequate financing and adequate opportunity to sell their exports to the industrial world, these countries should do quite well. And they underline the continuing difficult prospects of the low-income countries, which by and large have not benefited from the rather remarkable economic growth of the last three decades.

These projections, it seems to me, give rise to several conclusions. First, that under adverse circumstances—the low case—the middle-income countries are not going to provide the same stimulus to global economic growth that they did in the sixties and the seventies. I think it is worth noting, that under the low case the per capita gross national product in the industrial countries is, even under the worst circumstances, going to be nearly $3,000 higher by the end of the decade; where in the low-income countries, under those adverse circumstances, it will be precisely $10 higher.

I would conclude by saying that the Banks projections point out quite dramatically that the number of people living in what the Banks defines as "absolute poverty," is likely to increase if the low case comes to pass.

Finally, I would say that when one looks at the assumptions built into the World Bank's estimates, it becomes increasingly clear that their optimistic scenario is increasingly remote and even the low case could turn out to be optimistic.

Now, what are the policy implications of this for the United States? One thing is clear; the problems you are dealing with in these very useful hearings—problems of trade, of finance, of aid—

are all interrelated. These issues really are no longer a question of charity or what we do for the developing countries.

In table 4 of my statement, it shows that the congruence between developing countries that are the major export markets for the United States, that are the major customers of American private banks, and that are the major participants in the international financial system is rather marked. There countries are now of great importance to the United States in terms of our own economic and political natural interests.

Finally, I raise at the end of my testimony three questions for further consideration by the subcommittee:

First, how can the progress toward expanded world trade that had marked the world economy up until recent years be resumed because it is crucial to both the rich and the developing countries?

Second, how can the financial flows to the LDC's from both public and private sources in the short run be maintained, and over the course of the decade?

Third, how can flows of development assistance be expanded and focused increasingly on the low-income countries which are the proper recipients of foreign aid?

My conclusion is that despite the current amount of pessimism, collapse of the international economic system is not inevitable and it may not even be imminent. However, it will take intelligent leadership, political courage, and farsighted planning to restore global economic progress. And it will be much harder to restore global progress without establishing policies that will ensure the resumption of economic progress within the Third World.

Thank you.

[Mr. Sewell's prepared statement follows:]

Prepared Statement of John W. Sewell

Mr. Chairman, I am very pleased to be invited to testify on the needs and prospects for the developing countries. This is a subject of vital importance to the United States, yet it is one which is receiving far from adequate attention by analysts and policymakers in this country. The views on these issues that follow are my own and do not necessarily reflect those of my colleagues at the Overseas Development Council or its Board of Directors. I have drawn extensively, however, from ODC's publications, particularly from "U.S. Foreign Policy and the Third World: Agenda 1983," the next in the Council's annual assessments of American relations with the developing countries.

THE EMERGENCE OF THE DEVELOPING COUNTRIES

In the current uncertain economic situation, we lose sight of the rather remarkable aggregate economic progress that has been achieved by the developing countries over the past three decades. They have grown over that period at a more rapid rate than did the industrial world at any time during the industrial revolution. Even their progress during the troubled 1970's was in some respects astonishing. The annual GNP growth rate of the developing countries in the 1970s was 5.7 percent (compared with 3.4 percent in the industrial countries). As a result, the share of the developing countries in world GNP has grown from just over 15 percent in 1960 to 19.2 percent in 1979. And the World Bank projects that the developing world could account for as much as 25 percent of the world's GNP by the year 2000. Of perhaps greater significance is that their share in the increment of world GNP over the last decades has grown considerably. In the period 1960–67 their share in the increment of total GNP was only 15 percent; in the period 1973–79 it was over 30 percent. This progress, of course, was very unevenly spread and masked the continued existence of mass poverty, as well as vast differences in performance among and within countries. Nevertheless, it is accurate to say that the developing countries in the aggregate, and in some cases individually, are now major participants in the world economy.

This increased participation is reflected in their growing importance in both the world's trading and financial system. During the last two decades international trade expanded rapidly—its value increasing about 11 percent each year in the course of the 1960's, and 20 percent each year in the 1970's. The developing countries benefitted greatly from that growth, and a number of them became important exporters, not only of traditional primary products but of sophisticated manufactured goods as well. Despite protectionist measures, in the mid-1970's the manufactured exports of developing countries increased at an annual rate of more than 10 percent. During the decade of the 1970's, growth in trade provided an increase of about $145 billion (1980 dollars) in the purchasing power of oil-importing developing coutries. This is four times as much as the $36 billion increase in purchasing power attributable to external finance.

Second, the developing countries became important participants in the international financial system. This fact is reflected in the composition of overall capital flows between industrial and developing countries which have undergone a major shift. In the mid-1960's about 60 percent of total financial resources transferred from developed to developing countries were in the form of concessional assistance, with private sector flows accounting for the remaining 40 percent. By the end of the 1970's, the percentages had more than reversed, with concessional assistance falling to about 30 percent of the total, and private sector flows increasing to almost 70 percent. The growth in private flows (along with higher prices for oil and other products) has also led to a multiplying debt burden. Developing country debt grew at a rate of 23 percent a year during the 1970's and at the end of 1981 totalled $462 billion.

This shift in the pattern of financial transactions and the growing participation in the world trading system has considerable implications for the future. It means that the developing countries in the aggregate are now important participants, both in the stability of the international financial system and in the future growth of the world trading economy. In both areas, their growing importance to the economic health of the rich countries is under-appreciated in policy circles.

This growth, however, has been unevenly distributed. Some groups of countries have done much better than others. I would like to call particular attention to the record of the so-called "middle-income countries" (which includes, for these purposes, the oil exporters). The growth of the some 40 middle-income countries had been remarkable. These countries accounted for about 25 percent of the growth in world output in the period 1973-79, and in 1979 produced 14 percent of world GNP. According to an internal OECD study, "Their contribution to the growth of the world economy between 1973 and 1979 was larger than that of the United States alone, equal to Germany and Japan combined, and larger than industrial Europe combined." Similarly, the 1982 "World Development Report" of the World Bank concluded that if the fastest growing middle-income countries maintain their past development pace, they will, by the end of the decade, be approaching the income levels of post-war Western Europe and, early in the next century, will be well on their way to catching up with the industrialized countries.

This growth came about for two reasons: first, these countries were able to take advantage of a relatively open trading system to increase their exports of manufactured goods to the industrialized world at spectacular rates. And the growth rates have continued to hold up until the last year or so, despite economic slowdown in the industrial world. Second, these middle-income countries were able to take advantage of expanded private capital markets to borrow for investment. The oil shocks of the early 1970's and the inability of many oil producers to absorb their new revenues led to vastly expanded lending by private commercial institutions for investment in the Third World. These middle-income countries became a profitable locus of investment lending for American and European commercial banks. The public debt of the middle-income countries has grown from $55 billion in 1973 to $28 billion in 1980 and the lion's share of these increased debt has come from private bank lending. Indeed, commercial banks in the United States and Europe discovered in the growing countries of the Third World new profit centers which have helped to offset their lower earnings in a period of recession in the industrialized world. This, of course, has had two results: bank profits have remained high and their lending to the developing countries has by and large been for productive investment, which in turn generated exports for the developing world. But commercial bank lending has been relatively short-term when the need was for long-term capital. This mismatch is part of the cause of the current concern over developing country debt. By expanding trade and borrowing from commercial banks, a growing number of developing countries were able to tap new sources of development finance virtually outside the control and allocation of national governments or international institutions.

The result of this increased participation in the world's trading system and their experience in tapping new sources of development finance has been a seeming paradox. The economies of this group of middle-income countries are now to some degree more autonomous from the OECD economies than in the past. Their growth over the past decade was maintained independently of flowdown in growth rates in the OECD countries. In turn, their growth has had an impact on the industrialized world by providing stimulus to the world economy in general and growing markets for industrial-country exports in particular.

But because these middle-income developing countries are now more closely integrated in the world economy, they are even more vulnerable to developments in the international economic system, whether the threatened protectionism in the markets of the industrial countries that are crucial to their exports, the need to pay current (i.e., variable) interest rates on their bank borrowing, or the continued stagnation in the OECD economies. On the other hand, the emergence of the middle-income countries in the international economy has meant that they are a "significant" source of creating global demand, even though the industrial countries still command the heights of the world economy. It is now necessary to think of the developing world as an autonomous force, influencing macroeconomic interdependence in demand. In brief, economic interdependence has intensified. Therefore, the growing impact of these countries is important for American policymakers to understand because global growth in the 1980s will not be restored solely through policies designed to resume growth in the OECD countries.

THE IMPLICATIONS FOR THE UNITED STATES

The emergence of the developing countries as an important element in global economic activity has considerable implications for American policies. Increased cooperation with the Third World is needed to deal with a series of problems facing this country, ranging most immediately from the stability of the international trade and financial system to the longer-range problems of energy, food, and the environment. But I would like to focus attention today, however, on the importance of the developing countries to American exports because this issue receives insufficient policy attention.

Developing countries now purchase 38 percent of total U.S. exports; and exports to the developing countries, especially to the newly industrializing and middle-income countries, grew at a faster rate than exports to other industrialized countries. In fact, the growth rates in U.S. exports to the developing world held up amazingly well even after 1973, despite measurable slowdown in industrial-country markets. This growth has held up until very recently, but now we are seeing a sharp slowdown in rate of increase. The average annual growth in U.S. exports to the newly industrializing countries was over 16 percent in the years 1976 through 1981, but has dropped to 0.4 percent between 1980 and 1981. Similarly, for the middle-income countries the growth rates were over 21 percent for that same period, but slowed to 11 percent in the 1980–81 period. In fact, when the period January to July 1981 is compared with the same period of 1982, exports from the United States to the developing countries have turned negative as slowdown and retrenchment have caught up with the Third World.

TABLE 1.—GROWTH IN U.S. EXPORTS TO NONOIL LDC's

[Percentage change from previous year]

	1976	1977	1978	1979	1980	1981	[1]1982
Newly industrializing countries	1.6	4.5	23.0	31.8	25.8	0.4	−9.8
Middle-income countries	0.2	6.9	20.4	32.6	37.9	11.8	−11.9
Low-income countries	−27.1	−11.4	52.6	37.6	62.4	−3.8	−3.8

[1] Represents percent change from the first half of 1981 (January-July) to first half of 1982. Source: U.S. Department of Commerce, Highlights of U.S. Export & Import Trade, July 1982.

Source: International Monetary Fund.

This growth in exports from the United States to the developing world obviously has had an important impact on the U.S. balance of payments. In addition, it has affected both the quality and quantity of U.S. jobs. According to the Conference

Board, 79 percent of all new jobs created between 1977 and 1980 in the manufacturing sector were related to exports, with some measurable portion of them coming from trade with the developing countries.

U.S. trade with the developing countries follows an "advantageous" pattern. The United States exports heavy machinery chemicals and agricultural products to the LDCs in turn for imports of lower-cost consumer goods. In other words, trade between the United States and the developing countries exhibits what Princeton economist William Branson terms "structural interdependence". During the mid-1970's according to Branson, there was a quantum leap in U.S. exports of capital goods to the oil exporters and the newly industrializing developing countries. During a period where real U.S. GNP grew at an annual rate of 2.8 percent, total capital goods exports grew at 10.4 percent and exports to LDC's grew even faster. Branson concludes that growth in manufacturing capacity in the developing countries, based significantly on international borrowing, appeared as demand for exports of capital goods in the United States.

U.S. agriculture exports have followed a similar pattern. The past decade has been marked by what former Assistant Secretary of Agriculture Dale Hathaway calls the "internationalization" of American agriculture. In the 1950's exports were only 10 percent of cash farm receipts; by 1980 exports were 30 percent of total cash receipts. By far and among the largest source of new demand has come from a combination of the developing countries and the centrally planned economies, particularly in wheat trade. This explosive growth also had considerable beneficial impact on the U.S. balance of payments position. The importance of the LDCs is shown by the fact that in 1980–1981 when the value of U.S. agriculture exports fell by 8 percent (the first decline since 1969), the decline was due to lower imports by the developing countries (and, of course, Eastern Europe).

There is an additional area of concern here for American policymakers. The United States is losing its share of some of its developing-country markets to its competitors from Europe, Japan and, in some cases, the developing countries themselves. The United States share of developing-country imports of manufactures has dropped from 21.2 percent in 1962 to 15 percent in 1980. For the Middle East oil exporters U.S. share has gone from 29.5 percent in 1962 to 17.2 percent in 1980. The key issue, therefore, is what happens to industries in the United States if the developing countries continue to adjust to adverse economic conditions through a continuation of current low rates of growth.

PROSPECTS FOR THE DEVELOPING COUNTRIES

Progress by the developing countries in the decade of the 1980's at anywhere near a level of the 1960's or even the 1970's is going to be difficult to achieve. Projections of economic trends out in the future should be treated with caution for the obvious reasons that events can intervene to change even the best of analyses. (One only has to think of the largely unexpected increase in the price of oil in the past decade.) With that caveat in mind, however, one of the most useful analyses of the prospects of the developing countries can be found in the "World Development Report" issued each year by the World Bank. The last two of this annual publication have projected growth in the developing countries out to 1990 under a "high case" and "low case" scenario. Simply put, the differences between the two cases rest on three factors. The low case assumes a continuation of economic stagnation in the industrial world with inadequate flows of capital (both concessional and nonconcessional) and slow growth in trade. The high case posits non-inflationary recovery in the OECD countries, higher capital inflows, and expanded trade between developed and developing countries. The results are shown in the following table.

TABLE 2.—GROWTH OF GDP AND LDC's, 1960–90

[Average annual percentage change]

	1960–70	1970–80	GDP, 1980–90		GNP per capita	
			High	Low	High	Low
All LDC's	5.9	5.1	5.7	4.5	3.3	2.2
Low income	4.2	3.0	4.1	3.0	1.8	0.7
Middle income	6.2	5.6	5.6	4.3	3.4	2.1
Oil exporters	6.5	5.2	6.5	5.4	4.0	2.9

Source: World Development Report, 1982.

These projections also reinforce the earlier statement about the changing position of the middle-income countries. If events approximate the projections of the high case, the middle-income and oil-exporting countries will do well and their growth in turn will have a favorable impact on the industrial economies. Under the low case, however, they would not provide the same economic stimulus to the global economy as they did in the 1970's.

I would like to call particular attention to the poor prospects for the low-income countries. They are not good even under the more optimistic projections. For instance, even in the high case, GDP growth rates do not quite reach the levels of the 1960's. (This table does not show that under the low case projections, per capita GNP growth in sub-Saharan Africa would lag behind population growth, resulting in negative per capita growth!)

The prospects for the developing countries are seen more dramatically when they are converted to per capita income. The following table shows that even under the best of circumstances GNP in the low-income countries would increase from only $220 to $260, while per capita income in the middle-income countries would grow from $1,700 to $2,400. To put it another way, the increase in per capita GNP in the middle-income countries is 17 times the increase in the low-income countries.

TABLE 3.—GNP PER PERSON, 1980–90

[1980 dollars]

	1980	1990	
		High	Low
All LDC's	$850	$1,180	$1,050
Oil exporters	1,060	1,560	1,410
Middle income	1,710	2,400	2,120
Low income	220	260	230
Industrial countries	10,660	14,520	13,380

Source: World Development Report, 1981.

Finally, it is worth noting the impact of alternative prospects for growth on world poverty. As the figures in Table 3 indicate, the "gap" between rich and poor countries is not likely to diminish over the next decade. Even under adverse economic circumstances, per capita GNP in the industrial countries will be $2,750 higher in 1990 than in 1980, compared with an increase of only $10 in the low-income countries.

Perhaps more importantly, the number of people living in absolute poverty in the developing world is not likely to diminish. The Bank estimates that in 1980 about 750 million people in the developing world were living in absolute poverty. Under the high case their numbers would diminish by the year 2000 to 630 million. But under the low case some 850 million still would be living in absolute poverty after a number of decades of considerable aggregate economic progress in the Third World.

THE CURRENT SITUATION

It is now generally accepted that the continued growth by the developing countries after the first oil shock in 1973 had an important and measurable impact on growth in the North. This impact, of course, was a direct result of the growing economic importance of the Third World which emerged in the 1970's. As I indicated earlier, this progress continued up until the end of the last decade. However, the prospects for developing country growth are diminishing, and the possibility of achieving anything approximating the World Bank's "high case" is much more remote than when the projections were done. Indeed, the low case has become a much more realistic possibility. The key issue, therefore, is whether growth in the developing countries can be restored under an increasingly adverse set of economic circumstances. Or, perhaps conversely, the question should be on what will be the impact on the economies of the North if stagnation in the developing countries continues.

The importance of these questions is underlined when one looks at the following trends that will have a considerable impact on the prospects of the developing countries.

1. The combination of uncertainty and depressed economic demand has dampened the growth of world trade. The rate of growth in the volume of world trade has fallen from an average annual rate of 8 percent in the 1960's to 6 percent in the

1970's, to only 1.5 percent in 1980, and to no growth at all in 1981. In 1981, for the first time since 1958, the value of world trade actually declined by 1 percent.

2. The threat of protectionism is on the increase. Although there is no precise delineation of the extent of protectionist measures, the trend is ominous.

3. The debt of the developing countries continues to mount rapidly; and debt service ratios for many middle-income countries are approaching very high levels.

4. Financial conditions in the Third World are becoming highly politicized as more countries run into financial difficulties. The problem of Mexico, Brazil and others now command policymakers' attention throughout the world. The number of countries experiencing arrears on current payments has increased from 3 in 1974 to 26 at the end of 1980; and the amount in arrears had risen dramatically from $500 million to $5.5 billion by 1980. Between 1956 and 1974 there were 30 renegotiations for 11 countries involving a total debt of $7 billion. In the 7 years since 1975, however, there have been 24 debt renegotiations for 14 countries involving a total debt of about $10 billion. The number of countries and amounts involved are now even higher.

5. The ability of private financial markets to deal with the needs of the developing countries is coming into question. The growth in new lending by commercial banks to developing countries has slowed down according to the Morgan Guaranty Bank and, according to some analysts, could even turn negative if new lending slows as repayments mount. Private investment flows are not likely to take up the slack. To take but one example, U.S. direct foreign investment has declined dramatically. In 1979, the United States invested $24 billion overseas; in 1980 $18.5 billion. But in 1981 the total dropped to $7 billion.

6. Commodity prices are at a 30 year low. Despite their progress in increasing exports of manufactured goods, commodities still totalled 60 percent of the total exports on non-oil-exporting developing countries in 1980.

7. The growth in flows of official development assistance will be slower in the 1980's than the 1970's when ODC grew at 4 percent a year in real terms. The main laggard here in the United States which now contributes less than one-fifth of total OECD development assistance. Almost all other OECD countries are publicly committed to increased levels of development assistance.

CONCLUSIONS

The global economic system now seems to many observers to be entering a stage of crisis affecting both developed and developing countries. But collapse of the system is not inevitable and may not even be imminent. It is possible, with intelligent leadership, political courage, and farsighted planning, to restore global economic progress.

There is no doubt that restoration of economic growth in the industrial world, and particularly in the United States, will be the prime prerequisite for global economic recovery. But policymakers, particularly in this country, need to understand that the United States now operates in a truly global economy in which many countries outside the OECD have become important participants. It is no longer simply a matter of restoring growth in the industrial world and assuming that the rest of the world, and particularly the developing countries, will then follow. Recovery in the industrial world is indeed crucial to restored global economic growth; but in the 1980's, it will be much harder (and perhaps impossible) to engender global recovery unless the new importance of the developing countries is taken into account.

It is worth underlining in this context the interrelationship between the problems of trade, debt and commercial bank lending. As Table 4 indicates, there is a considerable congruence between the developing countries that are major markets for American products, major customers of American private banks, and major participants in the international financial system. Eleven of the top twenty trading partners of the United States are developing countries; most of these same countries also rank among the major borrowers from U.S. banks and among major developing-country debtors. Therefore, policy responses must deal both with issues of trade and finance.

TABLE 4—U.S.-THIRD WORLD ECONOMIC INTERDEPENDENCE

Developing countries	Major U.S. markets	Major LDC debtors	U.S. bank borrowers
Mexico	X	X	X
Saudi Arabia	X		
Nigeria	X	X	
Taiwan	X	X	X
Venezuela	X	X	X
South Korea	X	X	X
Brazil	X	X	X
Libya	X		
Hong Kong	X		
Algeria	X	X	X
Indonesia	X	X	X

Source: Overseas Development Council, 1982.

Taking in the LDC's "into account," however, and considering them as an integral part of any plan to foster global recovery, will not be simple. In the decades since World War II the diversity of the developing countries has grown, along with their role in world economy, to a point where there is now some question about whether the term "the developing countries" has in the future any policy utility. But for purposes of policy analysis, it still makes sense, at least in the period immediately ahead, to think broadly of the two groups of developing countries: the middle-income and low-income countries. (The oil-exporting countries can be included in the first group since in 1982 only three OPEC countries will be in surplus and the non-surplus OPEC countries face the same problems as non-oil-exporting middle-income countries.) The operational distinction between the two groups is simple: the middle-income countries have grown to a point where they now can take advantage of international markets in both goods and finance. The low-income countries, on the other hand, are not yet in a position to take full advantage of the international system; if they are to develop they will need increased flows of official development assistance for the foreseeable future.

This is not the place to discuss detailed policy proposals. Let me simply raise a few crucial issues in the hope that they will form an integral part of this Subcommittee's considerations in the future.

1. How can progress toward expanded world trade be resumed?—Experts disagree on the extent of protectionism now in effect, but the trends are disquieting. Both the developing countries and the United States benefitted greatly from the spectacular expansion of world trade that has taken place over the past decades. Those benefits are now threatened by the growing feeling that liberalized trade leaves at least some sectors in the United States at a disadvantage. It is important to underline that this country faces a considerable challenge in adapting its aging industrial structure to compete in developing-country markets and to deal with competition from developing-country suppliers of manufactured goods within the U.S. domestic market.

2. How can financial flows to the developing countries be maintained and expanded so that they can deal with their current financial difficulties?—In the short run, it is imperative that the growth lending to developing countries by commercial banks be maintained in order to avoid further contraction in the economies of those countries and a dampening effect on world economic recovery. Private flows, however, must be buttressed by increased lending from official sources, particularly the International Monetary Fund and the World Bank and other multilateral development banks. Developing countries must, of course, undertake painful but necessary programs of internal adjustment. But increased flows of capital are essential to the success of those programs and to ensuring that the international financial and trading system do not deteriorate further.

3. How can flows of development assistance be increased and concentrated increasingly on the low-income countries? This analysis has shown that the middle-income countries now are in a position to take advantage of an open international economic system to support their own development choices. The low-income countries, however, will remain dependent on concessional resources if they are to achieve any development progress. Here the role of the United States looms large because its performance in providing development assistance relative to its national wealth is lagging behind that of our industrial partners in the OECD. (Next year the United States will rank the lowest of all industrial countries in the percentage of its GNP devoted to development assistance.)

If it is accepted that global recovery (or renewed growth) cannot come about without paying attention to growth and progress in the developing countries, then these issues need urgent discussion. The reason is simple. If sufficient attention is not paid to Third World growth, the cost to the economies of the United States and other OECD countries because of lack of trade stimulus and its attendant benefits and because of threats to the stability of the international financial system (that is also of crucial importance to the rich countries) will be considerable.

Senator MATHIAS. Thank you, Mr. Sewell.

Mr. Mellor?

STATEMENT OF JOHN W. MELLOR, DIRECTOR, INTERNATIONAL FOOD POLICY RESEARCH INSTITUTE, WASHINGTON, D.C.

Mr. MELLOR. Thank you very much. I certainly appreciate this invitation to speak to you.

I am struck by the extent to which we seem to have variations on a rather similar theme here. I will abbreviate my comments which simply reinforce what my colleagues have had to say.

I would, however, like to point out that over the last decade or two, when foreign assistance, both in the bilateral programs and the international financial institutions, has been rather explicitly oriented toward problems of poverty, we have tended to miss the tremendous amount of growth that has begun to occur in the Third World.

We are now in a period in which that growth is very important to us. It is useful in that context to go beyond the aggregate figures that my colleagues put forth and point out what to many people seems a very startling figure—there are 700 million people living in Third World countries which have been experiencing better than a 4-percent rate of growth in per capita income through the last 1½ decades.

That is a rate of growth faster than was ever achieved in 2 successive years or more in the post-World War II recovery period in Europe. So, we are talking about large numbers of people experiencing very rapid rates of growth.

Of that 700 million people, half are in countries which are suffering from the high oil prices. In other words, despite the problem of high oil prices, they still managed to achieve high rates of growth simply because they have gotten their institutional structures and their economies in shape so that their efficiency in production process has been able to go up very rapidly. That is desirable for the developed countries of the world in terms of their own progress.

That group of fast-growth developing countries has a very great potential to be enlarged over the next decade or two. To cite an example that also tends to startle people, India is very close to being ready to move into a high-growth-rate period. If they were to do so, the population of Third World countries experiencing high growth rates would be several times the population of the United States. So, again we are dealing with a very major magnitude.

My colleagues here, and I believe your testimony in other sessions, bring out the tremendous benefits to the United States from this growth. I will not elaborate on those benefits except for one point.

They have dealt with the processes of trade, how these benefits of trade can come to the United States. I believe that someone pointed out the analogy between the benefits which the United States got in the 1950's and early 1960's in association with the European takeoff and the potential for a similar type of benefit now from the Third World countries.

I would like to make some specific comments about benefits to American agriculture—partly because my institute is particularly concerned with those issues and partly because I think these are some of the most important benefits to the United States.

Third World countries increased their net annual imports of basic food staples from 5.3 million tons in 1961-65 to 23 million tons in 1973-77, an addition of 18 million tons.

Projection of the underlying numbers depicts a further tripling by the year 2000, a further increment in annual imports of more than 50 million tons. That increment is a quarter larger than the Soviet Union's largest single year of grain imports which we all recognize as having been a dominant factor in agricultural trade.

A major share of that food import growth in the Third World countries is in the fast-growth developing countries, and the dynamic factor is not population growth but per capita income growth. In other words, we have been seeing very rapid growth in export markets for agricultural commodities in the United States coming from the Third World because of growth in prosperity in those countries, not because of population growth and poverty.

Economic growth of low-income countries is very good for American farmers. That process is now faltering. The most striking way to make this point is to display the import record of the 16 Third World countries with the fastest growth rates in basic food staples production.

I use the term "basic food staples" to cover cereals, which are very important to the United States, and the other basic sources of calories in Third World countries. But basically we are talking about cereals here—corn, wheat, rice, and so on.

These 16 countries are the agricultural growth success stories. They averaged a 3.9-percent-per-year rate of growth in basic food staples production in the period from 1961 to 1975. That is about the best one can expect to achieve over a significant period of time and over large areas.

During that period of great success in agriculture, those countries more than doubled their net food imports. Their self-sufficiency ratios for food declined 2 percentage points. the reason is simple. When low-income countries achieve high rates of growth of per capita income, these initially malnourished people spend a high proportion of increments to income on food. Thus, demand grows more rapidly than their best efforts can provide from domestic production growth.

Because livestock consumption picks up rapidly, imports of feed grow rapidly and remain high for a considerable period. We can say that an emphasis on agriculture and development insures a broad participation in development and is favorable to growth of agricultural imports.

I emphasize this because the United States in its foreign Assistance programs, of course, has been putting a lot of emphasis in helping developing countries improve their agricultures. I know that a number of farm groups in this country wondered if that was good for them and the record, I think, is very clear, it is surprisingly good for them at least for a considerable number of decades into the future.

As we have come to expect, the current recession has led to an increased emphasis in developing countries, especially those poised for rapid growth, on cost reduction, raising savings and investment rates, and other changes which increase the potential for growth when the recession ends.

Recessions are always very uncomfortable. But they do a little bit of good along the way. I think they have strengthened the market orientation. I think we see signs of that at the present time. I think that after we come out of this recession, a number of developing countries are going to be prepared to grow more rapidly even than they would otherwise have done.

We now, however, are in a period of severe danger. Again, others will point out the tremendous losses from the trade wars which may arise from recessionary situations, the political destabilization which destroys the foundations of growth, and the disincentives to save and to invest as prices decline and markets disappear.

There is a further danger of change in development strategy in response to the current recession and my point here, of course, is that while the initial stages of the recession may have had some efficiency-increasing benefits, it has now gone on to the point at which much more serious problems may occur—we may lose those benefits and then some.

From the point of view of productivity, efficiency, growth, and broad distribution of income, the best development strategy for low-income developing countries starts with agriculture, emphasizes importing high technology and capital-intensive goods, high employment and labor-intensive production, and high growth of exports to pay for essential imports.

If the trade environment is unfavorable, these countries will attempt self-sufficiency which means more emphasis on capital-intensive industry, less imports, less exports—but the former dropping more than the latter—and less emphasis on agriculture as resources go into import-displacing industry. Of course, there will be less growth in employment and even less growth in demand for food.

The latter is exactly the strategy initially followed by many developing countries and one they have now generally agreed is suboptimal.

It would be most unfortunate if the international economic environment turned them from that strategy just when they had begun to see its relevance.

I think this is to me an extremely serious problem in that we have been making very good progress in developing countries in moving toward more efficient processes, more nearly optimal policies, and we are about to see some of that set back rather substantially at the present time.

In the face of declining export markets in this recession, it is important that capital flows be reestablished to the high-growth-potential developing countries. They can then maintain imports and growth. That will sustain exports from developed countries and encourage increased global growth.

Thus, such capital flows are not inflationary because they elicit so much supply response. Imports are vital to a growth strategy that emphasizes employment and agriculture. Hence, maintaining the capacity to import influences the strategy of growth as well as participation in that growth.

Then, as global recovery occurs, the environment for reestablishing vigorous trade relations will improve.

I want to close with a comment on equity, since that has been, I think correctly, very much uppermost in our minds until this major recessionary situation set in.

Sustaining rapid growth, facilitating imports and trade generally, and encouraging agricultural production expands employment and provides food for the lower income people. No better, more effective means is available to raise incomes of low-income people.

Failure to provide financial flows at this stage will result in fewer jobs, less food, and increased poverty in the developing countries.

Thank you very much.

[Mr. Mellor's prepared statement follows:]

Prepared Statement of John W. Mellor

INTRODUCTION

I wish to make six points in this brief statement. First, the building of public support for foreign assistance, even to the International Financial Institutions, substantially on charitable instincts, while commendable, has diverted attention from the explosive potential for growth in the Third World. Second, Third World growth has been underway for some time and is poised for major acceleration. Three, that growth has highly favorable overtones for the developed countries. Fourth, the current global recession has initially strengthened the bases for that growth but risks a major unfavorable switch in development strategy. Fifth, there is urgent need and current means to reestablish that growth so that the favorable elements are strengthened and the undersirable elements are weakened. And, sixth re-establishing growth and its favorable forces is, in fact, a more effective means of achieving greater equity and meeting basic human needs than the more direct approaches to poverty alleviation favored over the past decade or two.

CHARITY AS A MASK FOR GROWTH

It is natural that a focus on charity and hence on the abject poverty that elicits charity, would leave powerful forces of growth unnoticed. Interest in poverty abatement without noticeable growth is likely to flag quickly, a tendence reinforced by gradual recognition that the inevitable income disparities within developing countries are associated with classes that not only could be doing more for their own poor, but who may even be diverting the charity of others for their own aggrandizement. In this context, even the escape to rapid growth goes unnoticed. It is quickly disembodied from its past or explained in cultural or other terms that allow no reproduction. Thus the currently underdeveloped are seen as endlessly trapped and finally of no interest. Neither is actually the case.

RAPID GROWTH IN DEVELOPING COUNTRIES

For the period 1966 to 1977, the developing countries of Latin America, Asia, and Africa averaged 3.7 percent in annual per capita income growth. That is an extraordinary record, particularly since it includes many economies experiencing essentially no growth at all, particularly in Africa, or more generally in the least developed countries. They still lack the basic foundations for accelerated growth. Some of the fast growers did so on price increases for natural resources like oil; others boomed simply on increasing efficiency—like Taiwan and Malaysia.

The point is more striking if the magnitude of the fast growth countries is spotlighted. Twenty Third World countries, containing some 700 million people, averaged growth rates of 4 percent or better in per capita income during the period

1970-77. Eight of these countries, all major oil exporters (Algeria, Indonesia, Iran, Iraq, Mexico, Nigeria, Saudi Arabia, and Venezuela), had an average per capita income growth rate of 5.6 percent per year. More symptomatic of the future, however, are the growth rates of the 12 rapid growth Third World countries that are not major oil exporters. These countries (Brazil, Hong Kong, the Democratic People's Republic of Korea, The Republic of Korea, Malaysia, the Philippines, Singapore, Syria, Taiwan, Thailand, Taiwan, and Turkey) also had an average growth rate of per capita income of 5.6 percent for the same period. They are now of course experiencing a substantial slowdown in their growth rates as a result of the current recession. These countries have the institutional base for sustained economic growth and are poised for resumption of that growth.

Some fast growth countries may fall by the wayside, although that is not a common event. More important, other countries are poised to move into this circle. Certainly India is close to fulfilling the basic requisites of rapid economic growth. That addition alone would move the collective population of fast growth countries to a population several times that of the United States.

DEVELOPMENT FAVORABLE TO THE UNITED STATES

I am sure other testimony will spell out the tremendous increases in productivity of resources that accompany economic development—how the processes of trade allow already developed countries to have their own income enhanced by those processes, the tremendous growth in importance of developing countries as a destination for United States exports and as source of raw materials, and the close analogy between growth in United States prosperity in the late 1950's and early 1960's in association with the European takeoff of that era to the similar situation available to us with respect to the Third World in the next decades. I will not elaborate on that powerful record and set of forces.

I would like to point out specific benefits to American agriculture. Third World countries increased their net annual imports of basic food staples from 5.3 million tons in 1961-65 to 23.0 million tons in 1973-77—an addition of 18 million tons. Projections of the underlying numbers depict a further tripling by the year 2000, an increment in annual imports of more than 50 million tons. That increment is a quarter larger than the Soviet Union's largest single year of grain imports. A major share of that growth is in the fast growth developing countries, and the dynamic factor is not population growth but per capita income growth. Economic growth of low income countries is very good for American farmers. That process is now faltering.

The most striking way to make this point is to display the import record of the 16 Third World countries with the fastest growth rates in basic food staples production. These are the agricultural growth success stories. From 1961 to 1975 these 16 countries averaged a growth rate of 3.9 percent per year in basic food staples production. That is a very rapid growth rate for agriculture, one unlikely to be topped for sustained periods over large areas. During their period of great success in agriculture, those countries more than doubled their net food imports. Their self-sufficiency ratios for food declined two percentage points. The reason is simple. When low income countries achieve high rates of growth of per capita income, these initially malnourished people spend a high proportion of increments to income on food. Thus, demand grows more rapidly than their best efforts can provide from domestic production growth. Because livestock consumption picks up rapidly, imports of feed grow rapidly and remain high for a considerable period. We can say that an emphasis on agriculture in development ensures a broad participation in development and is favorable to growth of agricultural imports.

DANGERS IN THE CURRENT RECESSION

As we have come to expect, the current recession has led to an increased emphasis in developing countries (especially those poised for rapid growth) on cost reduction, raising savings and investment rates, and other changes which increase the potential for growth when the recession ends. There are, however, severe dangers. Again, others will point out the tremendous losses from the trade wars which may arise from recessionary situations, the political destabilization which destroys the foundations of growth, and the disincentives to save and to invest as prices decline and markets disappear.

There is a further danger of a change in development strategy in response to the current recession. From the point of view of productivity, efficiency, growth, and broad distribution of income, the best development strategy for low income developing countries starts with agriculture, emphasizes importing high technology and capital intensive goods, high employment in labor intensive production, and high growth of exports to pay for essential imports. If the trade environment is unfavorable, these countries will attempt self-sufficiency which means more emphasis on capital intensive industry, less imports, less exports (but the former dropping more than the latter) and less emphasis on agriculture (as resources go into import displacing industry). The latter is exactly the strategy initially followed by many developing countries and one they have now generally agreed is sub-optimal. It would be most unfortunate if the international economic environment turned them from that strategy just when they had begun to see its relevance.

NEEDS FOR REESTABLISHING GROWTH

In the face of declining export markets in this recession it is important that capital flows be reestablished to the fast growth potential developing countries. They can then maintain imports and growth. That will sustain exports from developed countries and encourage increased global gorwth. Thus, such capital flows are not inflationary because they elicit so much supply response. Imports are vital to a growth strategy that emphasizes employment and agriculture. Hence, maintaining the capacity to import influences the strategy of growth as well as participation in that growth. As global recovery occurs, the environment for reestablishing vigorous trade relations will improve.

EQUITY IMPLICATIONS.

Sustaining rapid growth, facilitating imports and trade generally, and encouraging agricultural production expands employment and provides food for the laboring classes. No better, more effective means is available to raise incomes of low income people. Failure to provide financial flows at this state will result in fewer jobs, less food, and increased poverty.

Senator **Mathias**. Thank you, sir. Thank you for all of your testimony.

You are saying to us that notwithstanding the present situation, that the policies of encouraging development have by and large been successful.

I am wondering if we could pin down the indexes of success. I do not disagree with that. I think it is important to get that on the record. For example, the most basic of all indications of success in human society is longevity. What has happened to longevity in the developing world?

Mr. **Sewell**. Perhaps I can respond, Mr. Chairman.

Measured by both economic and social indicators, there has been a remarkable amount of development progress in the world. If I recall correctly—and I could happily give you the exact figures, I do not carry these in my head—life expectancy in the developing countries has lengthened by 15 years in the last three decades.

Senator **Mathias**. When you talk about human rights, the right to live as long as people in other parts of the world is a pretty basic human right that has been reinforced by these policies.

Mr. **Sewell**. Literacy is up. Infant mortality is down. Major diseases have been eradicated, for instance, smallpox. If you go into a hospital with a case of smallpox they would not know what you have because nobody has seen it for a long time.

Now, there are some caveats to this.

Senator **Mathias**. Before you get to the caveats, what about per capita income?

Mr. **Sewell**. Per capita income is up somewhat. I do not have the figures in my head.

Mr. **Mellor**. Well, you know, I would put it differently on that. What has happened is that we have continually added substantially to the number of countries in which per capita income is growing very rapidly. Most of those countries were considered failures 15 years ago—no hope for them.

In 1955 everyone knew Taiwan was never going to develop, partly because they could never get their exports to increase very rapidly. That seems ridiculous now.

Most of Southeast Asia is moving very rapidly. You were before the recession getting, as I point out, 5.6 percent growth rates in per capita income in Southeast Asia. Nobody was expecting that 15 years ago.

Then you have a whole bloc of countries, including most of Africa and still most of south Asia, where per capita incomes have been going up very little if at all. But those countries will gradually begin to cross over into the rapid-growth situation as well.

Senator **Mathias**. I want to come back to the distinction between those that have moved faster and those that have held back. But, let us get to Mr. Sewell's caveats.

Mr. **Sewell**. Well, my caveats are going to be much the same. A considerable number of countries have not benefited from this progress to anywhere near the same extent. These countries are largely in sub-Saharan Africa and south Asia. A remarkable example, by the way—as John Mellor indicated—is India's current progress and future potential. India, I suppose, is the classic "basket case"—if you want to use the pejorative popular phrase. But is has made considerable development progress.

The other caveat is, that within certain countries large numbers of people have not benefited from overall economic growth. And this is where I think equity still needs to be addressed in the direct sense. Although the aggregate economic progress for a country like Brazil has been remarkable, a large number of people within Brazil have not shared in that progress, and that issue therefore needs separate address.

But with those two caveats, it is the classic case of the glass being either "half empty" or "half full." We have come a long way since 1950. The gap, as some of the figures that are in my testimony indicate, between the rich and the poor countries, however, is still with us and will be well into the future.

Senator **Mathias**. Of course, one problem that we have not overcome is the way the Lord doled out the Earth's bounty. Sub-Saharan Africa, which you mentioned, is one of the less successful areas. It looks a good deal like the Arabian Peninsula but there is a big difference in the economic results.

Mr. **Sewell**. If I can respond to that, Senator, there also are historical reasons for Africa's under development. But one has to be a bit careful of pessimism. I suppose someone who crossed the San Joaquin Valley 100 years ago on a horse or a wagon and was told that a century later this will be the "market basket" for most of the United States would have raised some questions. Yet, with the proper application of capital and technology, that area of California produces a great deal of agricultural produce for the rest of the United States. Areas of West Africa have that same kind of potential over a longer period of time.

Senator **Mathias**. If you can find the water.

Mr. **Sewell**. Well, the water is there, but it requires irrigation. If you look at the Niger or Senegal River basins, it is really quite remarkable what they can grow with a little bit of irrigation, one gets better tomatoes, I may say, than at your friendly neighborhood supermarket.

Mr. KRAUSE. Senator, if you try to identify the factors that distinguish between the developing countries that have done well and those that have done less well, they are commitments to development, soundness of institutions, achievement of stability; market orientation of their policies, and outward orientation of their policies.

The Lord did not treat Korea very well except that it has a very vigorous population, which they recognize as their major source of strength. The have done very well.

Senator MATHIAS. I think these are facts that need to be widely recognized, both in the Congress and around the country because there is a tendency to write off the development programs of the last generation as having been wasteful giveaways that have not produced any results—just pouring money down a rathole. I am sure you have heard all of those phrases and more.

The facts are that there has been remarkable development, and that this particular moment in history ought not to obscure the fact that there are human gains, gains that may not be reflected on the current balance sheets but are reflected in people's lives in a very significant way.

Speaking of balance sheets, let me go to Mr. Krause and ask him what he means in his statement—a phrase that gives me some concern—when you say that, "We need reasonable behavior by our bank examiners." [Laughter.]

I thought I would get ahead of Senator Proxmire on that one.

Senator PROXMIRE. I underlined that, too.

Mr. KRAUSE. The point I wanted to make is that there is a degree of judgment call as to when to put a loan on the nonoperating basis. The distinction is between a loan on which there is currently no cash being received by the bank or less than the full interest payment, and the service is being absorbed in a larger principal of the debt.

That is open to interpretation as to whether it is being serviced or not. And of course the distinction is critical from the bank's point of view, whether capital has to be allocated to cover it in terms of loss provisions or whether capital remains intact.

Now, it is possible to read the press of this country and believe no country can ever repay its debts. And indeed, there have been some misleading statements by bankers that imply that no country ever repays its debts.

Senator MATHIAS. Some very prominent bankers.

Mr. KRAUSE. Yes. I think if bank examiners hear those statements, taking their jobs seriously, they will then question whether those loans that the banks say are still operative and in fact are.

I think what has to be done is to treat each of these countries on a case-by-case basis. Just because there may be one African country that in fact should be on the problem list does not mean that all African countries are, and certainly the same in Latin America.

It is this that I refer to. It is a process which a study by someone in the World Bank called regionalization. And bank examiners may bring guilt by association. Each of these countries has its own separate circumstances and the loans should be evaluated separately.

Senator **Mathias**. I feel better about that statement now than I did when I first read it.

I would agree with you that you should not condemn all African countries because one African country is in trouble, or South America, or any other region in the world. I would think that band examiners should make those kinds of discriminating judgments.

We had some discussion this morning about the distinction between liquidity problems and solvency problems, which bear upon the same general question.

I was concerned when I first read that, however, that you were advocating the kind of treatment that some corporate officials today are pleading with their certified public accountants to give them, you know, "It depends on you whether our company is going to stay alive for one more quarter." That, I do not think we want to have in either public or private financing.

One more question, and then I want to defer to Senator Proxmire.

You referred to some institutional changes required in bank lending to developing countries to prevent a recurrence of today's problem. What would you like to see done?

Mr. **Krause**. Mr. Chairman, I think there is a structural weakness in bank lending today. Because of competition among the thousands of banks in the world, we tend to have overlending by the banks. And because of the flexibility that borrowing from banks provides to developing countries during good times, we tend to have over borrowing by them.

So, we have a condition whereby under normal times you will see this indebtedness rising faster than it should. Therefore, when you get into bad times, it starts to contract.

The institutional change that I would suggest would be recognition an intermediary is necessary. That, in my view, should be the IMF. The IMF should put guidelines on what is responsible borrowing behavior by particular countries. And that banks that lend in excess of that would, in fact, know that they are being irresponsible, and governments within the developing countries would, in fact, recognize that they are becoming irresponsible.

Mind you, these are not binding. I do not think we are at a point where we want to give that sort of sovereignty to an international institution. But an impartial institution giving sound judgments, I think, can go a long way to solving that institutional problem.

In addition, the IMF ought to be able to certify the correctness of figures that banks have to deal with. Sometimes that is not currently possible. I think that is an institutional job that an international organization ought to provide.

Senator **Mathias**. This would imply duty on the banks to report their loans.

Mr. **Krause**. It should in my view involve the U.S. Government's willingness to turn over lending reports to the international institution and therefore the banks know about this before they submit those reports to bank examiners and Federal overseers.

Senator **Mathias**. But that is the mechanism that you would use to make this information available.

Mr. **Krause**. Yes.

Senator **Mathias**. Thank you very much. Senator Proxmire?

Senator **Proxmire**. Thank you, Mr. Chairman.

Along that same line, Mr. Krause, I asked Mr. Blumenthal this morning this question and I would like to ask you the same one. Should we have a statutory limit on the amount of loans within a country by a particular bank?

For instance, should a bank be required to limit the loans it makes to any country to, say, 10, 15, or 20 percent of its capital, would that be logical?

Mr. **Krause**. I think there is such a thing as sovereign risk, and that all loans to one country may in fact have a certain amount of correlation in the risk that is involved, so that it does make sense.

I will not tell you what number it is because I am in no position to do that. But we have to identify in our regulation different degrees of risk. So there is a risk of all loans to one country even though some may be to governments, some guaranteed by governments, some to multinational firms' operations in those countries. The bank has different risks involved.

Senator **Proxmire**. Why should we not put that into effect before we replenish the IMF? The feeling was this morning that that was maybe a good idea but let us take our time, study it. We have to go ahead with the IMF replenishment more promptly, sometime this year.

Mr. **Krause**. I think the need for IMF replenishment is a present need, and we see that need. How we in fact effectuate and on what numbers we effectuate this sort of limit within banks, I think, needs study.

I do not think we want to do it without some mature judgment over what would be helpful.

Senator **Proxmire**. What is your position on whether or not we should do that first before we go ahead with the replenishment?

Mr. **Krause**. I would see replenishment going on first and a parallel study, not implementation.

Senator **Proxmire**. Well, a parallel study. Do we not lose a lot of our leverage once we go ahead with the, say, 40- or 50-percent increase in the IMF funds?

Mr. **Krause**. I am not clear, Senator, leverage over whom that you would see us losing?

Senator **Proxmire**. The leverage that Congress might exert vis-a-vis the regulatory bodies. I am concerned. I think the world of Paul Volcker; he has done a fine job under tough circumstances. But I must say, I am somewhat alarmed at the report that was in the New York Times yesterday which said:

> Federal Reserve Board Chairman Paul Volcker has encouraged bankers to cooperate in the effort to finance Third World companies through this difficult period. He has brushed aside some regulatory obstacles that might have inhibited the banks. New loans to nations working out deals with the IMF will not be classified as substandard, doubtful, or losses, all categories that could call for extra reserve requirements for the banks.
>
> Lending banks working effectively together to clearly justify transitional needs should be able to provide the necessary margin of finance.

I realize this is a delicate and difficult area, but it would seem to me that if a loan which is more than, say, 90 days overdue in the interest being paid on it, is not classified as nonperforming when you have this special treatment of foreign loans, that you have a situation in the first place that does not provide the kind of full disclosure that has, I think, helped our capital markets enormously.

And in the second place, you have a special treatment for foreign loans compared to domestic loans.

Mr. **Krause**. Senator, I think there are many domestic loans where the interest is also being added to principal, that are not on the problem list.

Senator **Proxmire**. They ought to be. Certainly, it should not be a policy on the part of our top regulator that we want to help out the farmers or we want to help out the steel people, or auto people, or whatever, or even help out a country and therefore we should not put it on a nonperforming list because it is not convenient for our policy at that time.

Mr. **Krause**. Even under the best of times the borrowing needs of companies expand and indeed, some of our fastest growing and most prosperous companies expand. Now, they may pay interest and borrow more—whether they do it from the same bank or different banks.

I do not think that necessarily the conditions that were specified, that is borrowing money to pay interest, need imply that is in some way a very problem debt.

The issue that you come to in trying to improve the regulation of banks is a multinational issue. It is not just a U.S. Government issue and many countries are concerned about this. The Germans are worried about their banks, the Austrians are. All of the countries are, certainly the Japanese.

Therefore, I think it is in this atmosphere of recognizing that something has happened that is not desirable which gives us the opportunity. The recognition of the problem gives us the opportunity to deal with it rather than holding an IMF replenishment in jeopardy.

Senator **Proxmire**. Well, as I understand it, Treasury Secretary Sprenkle testified before the Banking Committee the other day and indicated that the timing on this was that we had about a year. You do not have to make the decision next month or as soon as Congress comes back, we can be somewhat more cautious and careful about it.

Why not use that year to get these reforms in our banking system so that we have the fullest possible disclosure and our investors and others are protected?

Mr. **Krause**. What I am suggesting, Senator, is that it cannot be done with U.S. legislation alone. That this is in fact an international problem and that regulating just U.S. banks would not in fact solve the problem. It has to be done with the bank regulators of all the major countries. That is why it takes a rather long time to do it.

Senator **Proxmire**. Well, it would solve the problem for us. It would solve the problem as far as our banks are concerned. That is what we are concerned about. We cannot expect to solve the problems for Germany or other countries who are lending money. As a matter of fact, we may set a good example for them—we may not.

Mr. KRAUSE. Sir, it does not solve the problem for U.S. banks because if our banks are the first to lend and all of those are done within guidelines, and there are loans by other countries' banks that are greatly in excess of what is responsible and the country then defaults, our banks are no better served.

Senator PROXMIRE. Of course they are. Our banks are better served if they lose 10 percent of their capital instead as if they lose 100 percent, or 80 percent.

Mr. KRAUSE. It does not protect the system, and it does not protect U.S. banks.

Senator PROXMIRE. It does not protect the system, but it protects a particular bank if it is limited in the amount of risk it can make in a particular country that may fail.

Mr. KRAUSE. To the amount of its loan it is protected. But it does not protect the solvency of the U.S. banking system.

Senator PROXMIRE. Well, I think the solvency of the U.S. banking system, you are right about that. But I do not think that is a real question—perhaps it is.

You indicated that the causes of the difficulty for the LDC's were commodity price drops, a 38-percent drop, you indicated; interest rate rise which is maybe 200 to 300 percent—there has been a colossal rise, international trade contraction of 10 percent.

The difficulty with each of these reasons—and I think you are absolutely right, those are the principal reasons. Any mistakes they have made in fiscal policy or in whatever other matter that was within their control is probably quite limited.

Under these circumstances it would seem that we are still taking quite a risk here because commodity prices might continue to drop, interest rates might go back up again. International trade, as you indicated, might very well contract and therefore the conditionality does not assure us that we are going to get our money back—or that our banks are going to get repaid. Whether the IMF is going to be repaid. Is that not right?

Mr. KRAUSE. This is correct, Senator. If we have continued stagnation of the world economy, on recovery in the United States, then we are going to see weaknesses in the world economy come forward. This will be one of them. I will not be the only one.

Senator PROXMIRE. No matter how strong the conditions are.

Mr. KRAUSE. No matter how strong those conditions are.

Senator PROXMIRE. Right.

Mr. KRAUSE. If we have continued stagnation of the world economy, I would think in 1983 we will find ourselves in an inflection point and into something that we will call a depression.

Senator MATHIAS. Could I interrupt at this point because I want to relate this last question and answer to the one that preceded it.

Senator PROXMIRE. Yes, indeed.

Senator MATHIAS. Senator Proxmire said that Mr. Sprenkle had testified that there was a year in which to act. Does not that year reflect the fact that the IMF current assets might carry the load through 1983, but that if you waited until the end of 1983 to act then you would be up against the wall?

And if, in fact, trade contracts and commodity prices continue to fall, the IMF would then be without the necessary resources to cope with that continuing problem. You would then be acting in a climate of desperation which could be avoided by increasing the quotas today.

Senator **Proxmire**. Before you answer, let me just say, I do not want to misinterpret Secretary Sprenkle. Secretary Sprenkle indicated that there were various phases of action that would come up during the course of the year, and that of course he hoped that Congress would act promptly. But that the final—as I understood it, perhaps I misunderstood him—the final decision would not have to be made until late in the year.

Mr. **Krause**. I certainly would not want to put my knowledge and understanding of the problem as implying that it is better then Under Secretary Sprenkle's who knows more about this subject than I do.

What I want to say is that even if we had the IMF replenishment, to the most generous amount that is now being suggested, if we do not have a world recovery this year, that is not going to be adequate.

And indeed, we may have a depression even if we had a bank check to give the developing countries because under those circumstances they may not want to borrow. That even if the credit is made available to them, the better part of wisdom on their part might be to renege on the debts.

Senator **Proxmire**. That is exactly the point I wanted to come to there. You seemed to indicate the strong probability that we would have a recovery.

That seems to me to contradict what seems to be a developing consensus, as I understood it. Even the administration has indicated that in 1983 they expect a recovery but a very weak recovery, between 1 and 2 percent of our gross national product in real terms growth.

As you indicate, the European countries perhaps will perform not that well. That does not leave much prospect for the kind of recovery that you thought was necessary.

You indicated, as I understand it, a 1-percent recovery by the industrial countries would probably spell a very serious problem, if not disaster, for the LDC's; is that right?

Mr. **Krause**. That is correct.

Senator **Proxmire**. Why do you differ from the consensus, then? Or am I misinterpreting the consensus?

Mr. **Krause**. I think you want to interpret forecasts on a fourth quarter to fourth quarter basis. A lot of the decline in the forecasts year over year that has been suggested for the United States in 1983 is from the fact that the end of 1982 was weaker than we were expecting.

Under the administration forecast—which I think incidentally is a bit too pessimistic—but even under that forecast we have fourth quarter to fourth quarter growth in the United States of about 3 percent.

I would not be surprised if it was not 4——

Senator **Proxmire**. Well, this is something else. Mr. Krause, I love you. You know, you do not see many economists who will say that any administration has ever been too pessimistic—if so, it will be a world record.

Can you remember any administration which did not follow Herbert Hoover and say, "Prosperity is just around the corner?" They all said it. The Carter administration, which I thought did a good job in many respects, was always saying it is coming up. And of course the Reagan administration said the same thing.

Administrations, by their nature—they do not want that old self-fulfilling prophesy of saying, "Things are gloomy, we are not going to do too well," so they tend to be optimistic.

Mr. **Krause**. True Senator, but very few administrations have been more embarrassed by overestimating their economic outlook than this one. It might be the better part of valor to estimate just a bit on the cautious side this year.

Senator **Proxmire**. But then you put an awful lot of your money on going out in 1984. Is that not a long way away? Is that not like predicting the weather for the Redskins game next Saturday?

Mr. **Krause**. Senator, if the United States does not have a recovery in 1983 after having a 25-percent cut in personal taxes, a remarkably large increase of expenditure; if we cannot have a recovery in this economy after we put so much steam in the fiscal side, then we would have to think about doing something even more drastic because——

Senator **Proxmire**. You know the answer to that. That big tax cut by the administration is a disaster because almost everybody recognizes it is spelling these colossal deficits. Even if we start to recover you will have deficits. It will do exactly what happened in 1980 and 1981, interest rates go up and you choke it off.

The interest-sensitive part of the economy, the homebuilders, the auto buyers, the small businessmen who borrow money, cannot buy because interest rates go up. The Federal Government is hogging all the credit market. Is that not right?

Mr. **Krause**. What we have done is provided 2 years of fiscal stimulus equal to the 2 most stimulative years of the Vietnamese war.

Senator **Proxmire**. With what result?

Mr. **Krause**. And we followed a tight monetary policy at the same time. It was a totally unbalanced policy. It would no doubt have been better to have less fiscal stimulus and easier money.

However, having gone through that, you then cannot turn it around on the dime because you have built in pessimism in the business community which must be overcome in order to get a recovery.

So, what I am suggesting is, having done all that, if we get to the third quarter of 1983 and we still have no recovery, then we have—through what we have done in the past—created a situation that is much more difficult to turn around.

It is not like we have had a typical recession, we would have had 3½ years of recession. And that has to leave a legacy.

Senator **Proxmire**. The advice that we got this morning from Mr. Blumenthal in great detail was that we should cut spending, increase taxes, greatly change our fiscal policy—reduce stimulus, as you define it. I think that would be helpful.

But you seem to feel that the real expansion is coming from the fact we are going to run the biggest deficit ever.

Mr. KRAUSE. My view is that the emphasis has to be on the outyear deficits. I would not want to reduce the deficit immediately. I want to reduce the outyear deficits so that the atmosphere for monetary policy can permit not only a reduction in short-term interest rates, but the market would then permit long-term interest rates to decline because they could view a recovery with then a sharply declining Government claim on the savings of the country.

Senator PROXMIRE. All right, I do not think we differ greatly on that.

Mr. Mellor, I want to get back on that subject—and I apologize for getting all over the place on broad economic policy that is not as directly related to our testimony.

To the extent that these countries continue to develop agriculture—you spoke to that—that was an interesting observation. You indicated that some people in agriculture feel they would import less.

You were very strong in your assurances, however, that it is decades away from the time that they will not be continuing to import heavy amounts of wheat, for example, from this country, and feed, so they can feed their animals.

How are you so sure about that?

Mr. MELLOR. I think the critical factor here is that you are dealing with countries in which existing per capita consumption of food is very low, so that you have people—and particularly in the lower 40, 50, 60, 70, 80 percent of the income distribution—who will spend 60 or 70 percent of additions to their incomes on food.

If you have a high growth rate in income in the 4, 5, 6 percent range which so many of these countries are now achieving, there is no way that domestic agriculture can keep up with that.

Let me just add a little bit further to it. The only chance of coming close to meeting those rates of growth and consumption from domestic production would be for those countries that have a very rapid rate of technical change so that their yields per acre go up very rapidly to also expand their land area under cultivation fairly rapidly.

Now, there are some countries that can do that, Brazil is a case in piont. To some extent, Thailand can bring considerable additional land into cultivation. We can find a few African countries, but not many, that can do that.

When they add together very rapid growth in the area under agriculture and high growth rates in yields, they may be able to match their domestic consumption. But most Third World countries are right out on the edge already in land area under cultivation. They are not going to be able to bring in a great deal more.

Therefore, they have to rely almost entirely on yield increase. They are already counting on yield increase for 70 to 75 percent of their additions to production, and that ratio is going to increase.

We just cannot move yields per acre up continuously over a substantial period of time over large areas at these 3½, 4½, 5½, 6 percent growth rates.

So, I think I say this with considerable assurance, this is not the year to be hopeful about agriculture when we see the plummeting in prices and so on, but that is the product of the global recession we are in now and hopefully is not symptomatic of the future.

Senator **Proxmire**. I appreciate that. That has been the consistent experience? You indicated some exceptions, but by and large, overall, there is a general recognition that this is going to work out to more export rather than less?

Mr. **Mellor**. I think the fascinating figure is the one I quoted, taking the 16 Third World countries that have been the great success stories in agricultural growth, they doubled their imports while they were being such success stories.

Now, Taiwan is of course an extreme on this because it does have a very high population density. But we always point to Taiwan as being a great success story in developing its agriculture. It has done extremely well in agriculture—partly because of the tutelage from the Japanese in their colonial period and so on.

But whatever the reason, they have done very well. They were a net exporter of basic food staples—basically that means rice and other cereals—in the early 1950's.

They now import 60 percent of all the cereals they consume in the country. Now, that is of course primarily for livestock feed, but so what? What is happening is, their livestock consumption has gone up. They produce a lot of livestock at home. They cannot possibly generate all of the cereals to feed the livestock from their domestic production.

So, they have become a very major importer from us. We are going to see more and more of that kind of effect as developing countries reach the fast growth situation.

Senator **Proxmire**. Senator Mathias was pointing out the fact of rapid population growth and I guess it cuts both ways, in a sense.

But I would like to ask you, Mr. Sewell, what effect would a vigorous, aggressive policy of family planning have—hopefully a successful policy of family planning—in holding down population, what would that contribute to this situation? Would it help, or would it hurt?

Mr. **Sewell**. Do you mean the overall economic situation?

Senator **Proxmire**. That's right.

Mr. **Sewell**. Well, clearly, it would help.

Senator **Proxmire**. Obviously, it would help the standard of living in these countries.

Mr. **Sewell**. Yes, over the long run.

Senator **Proxmire**. But would it help our exports, would it help our trade?

Mr. **Sewell**. I think John Mellor's calculations on food imports hold for a whole range of other imports. As countries grow, the demand for imports from the industrial world are also going to continue to grow. Of course, over a longer run we are going to get a much more diverse world with trading going in a variety of patterns.

It seems to me that population growth is still one of the key challenges facing us. But there has been progress. It is within everybody's memory here when President Eisenhower said that the United States will never deal with these kinds of programs, and when most developing countries had no population policy at all and did not want to discuss it.

Senator **Proxmire**. That has changed quite a bit, has it not?

Mr. **Sewell**. That has changed. The rate of increase is slowing down.

Senator **Proxmire**. Does not China have a very disciplined policy?

Mr. **Sewell**. That is right, and other countries have also. And now the demand for family planning programs—both contraceptives and education—is far beyond the supply. So, you have an organization like the U.N. Fund for Population Activities not being able to meet the demand from developing countries for family planning programs. The question is how to move even more rapidly in order to bring down the ultimate size of world population as low as possible. The built-in momentum, of course, into the system because of what my demographer friends refer to as fertility decisions that have already been made, is very great.

Senator **Proxmire**. I just wonder what the immediate economic effects over the next 3 or 4 years.

Mr. **Sewell**. The immediate economic effects will be zero because the increase is going to take place no matter what is done. The real question is what happens in the early years of the next century when you will begin to see the impact of programs undertaken now. Clearly, a world with a population of 7 billion will be much easier to manage than one of 10 or 12.

Senator **Proxmire**. I would like to ask each of you if you could respond to this next question. As you know, the administration is recommending a $7 billion to $9 billion U.S. increase in the IMF quota which will bring it up substantially.

Would you tell me what you think the economic effects would be both of making such a commitment and not doing so? If we do not provide those billions of dollars, what is the effect on our economy, will it be default by the Third World on its debt? Would banks fail? Would interest rates rise? Would banks be more cautious in their lending? Would recession be prolonged?

What would be the effect on the U.S. economy of another $9 billion out of our economy in loans to foreign countries? That credit obviously would not be available domestically.

Mr. Mellor?

Mr. **Mellor**. I think what concerns me the most on this is that where developing countries believe they can keep their growth rates going, if they can just keep a capital flow on during this recessionary period so that they can keep their growth rate going and come out of the recession in good shape, where they are in a position to do that, it seems to me very important that those flows be available because these are countries with tremendous potentials for growth that will make a very great contribution globally as we come out of the recession.

It seems to me it is very important to see to it that any source of flow of capital to them be opened up.

Senator **Proxmire**. I am going to sharpen my question. What effect will it have on this country if we do not make it, and if we do?

Mr. **Mellor**. I think in the long run what you will have done is turned a lot more developing countries inward looking, and therefore we are not going to get the benefits of an interaction with these prospering parts of the world. It would be sort of like turning

Europe inward looking in the 1950's. We would then have lost the tremendous benefits which we got out of that process as they prospered.

So, I really am concerned. And once you get a country turning inward in its policy it is something that gets politicized and gets built into the political system. You are not going to turn that around in a year or two.

So, it seems to me we have had some long-term processes going in the right direction over the last couple of decades. Now we are facing a situation in which we may begin to turn those around. That worries me very much.

Now, in the short run—I suppose my colleagues can comment more directly on this—but it seems to me there are serious problems of default coming in. There are, it seems to me, very serious shortrun effects of this type coming on.

I was simply trying to address the longer run problem.

Senator PROXMIRE. Let me ask Mr. Krause.

President Schultze of the American Economic Association this morning testified that your figures show that no increase in loans to LDC's would mean a drop of 3 to 5 percent in the growth rate within the countries, and a 1½-percent drop—I should say in U.S. growth.

Do you have those figures?

Mr. KRAUSE. Yes; those figures come from a paper that I wrote for Goldman Sachs, which I will be happy to put in the record, Senator.

Senator PROXMIRE. Good.

Mr. KRAUSE. That was a conditional calculation, meant to give some dimensionality. It is not an uncritical forecast which you would in fact have to put through a big econometric model because if there was no growth of credit to LDCs and there was a reduction of exports from the United States as the result, it might be offset by monetary policy and the other things that we might do to recover from that.

This was a conditional estimate of what would happen if the world had to live with no growth of credit to the LDCs and they responded by cutting their imports.

Senator PROXMIRE. Is that a worst-case analysis, the worst-case consequence, the 3- to 5-percent drop in growth?

Mr. KRAUSE. It is of that kind, yes. It is a worst-case scenario.

And to come to your question about the IMF quotas, I think that it would not be desirable to keep resources from going to the IMF. But it is possible that we could work around that lack of resources to the IMF through bilateral country-to-country lending or indeed scrounging up credit from countries that are not currently borrowers.

What it would do clearly, however, is take the IMF out from the center of the system where they have a tremendous role to play to regularize it from the kind of semichaos it is in now. And in that sense it would be a lost opportunity to strengthen our institutions to make them work better.

Senator PROXMIRE. It is such an important decision, I wonder if it would be possible to put this into an econometric model so that we have some notion of the effect.

I think—I could be wrong—but I think you are going to have a lot of trouble. The reaction in the House Banking Committee to this was very critical. They may support it, but they were quite critical and I think there is a lot of feeling here at a time when we have such a shortage of credit and we are in such difficulty that we should replenish to the tune of $7 to $9 billion.

I think an econometric study, responsible, independent, would be very helpful.

Senator **Mathias**. As a first step we will ask Mr. Krause to give us a copy of his Goldman Sachs study.

Mr. **Krause**. Yes, indeed.

Senator **Mathias**. And without objection, that will become a part of the hearing record.

Senator **Proxmire**. Mr. Sewell, would you like to comment?

Mr. **Sewell**. Senator, I will not add much, but let me say strongly that I think a refusal to provide the IMF with additional resources would be disastrous. It would be disastrous if only in psychological sense. After all, it was the failure of a bank in Austria in the years which triggered the 1929 collapse and it was the assassination of the Archduke in the Balkans that triggered World War I.

I take your question to mean the implications of no U.S. participation in the next quota increase in the IMF. I think that would be a signal which would have ramifications far beyond the amount of money involved. It would, it seems to me, call into question—as Larry Krause said—the viability of the IMF and its central role in the international financial system. It would send a signal to bankers around the world to start withdrawing from further lending to the developing world. And it would signal to the world that the United States was withdrawing from the leadership we have exercised so far in the post-war world. Finally, it would give impetus to the kind of world depression that Larry Krause alluded to earlier.

But I also would stress that an IMF quota increase is really not the panacea that some people may think. It will enable us to maintain the system. Over the longer run we need to address the fact the expansion of private bank lending over the past decade reflects a failure of public policy. If we had attempted to recycle the surplus funds that were handled by the private banking system after 1974 by a negotiated agreeement between governments, we probably still would be discussing the issue. The private banks undertook that function for the obvious reason they were making lots of money out of it. But of course, they lent relatively short-term for long-term productive investment in the developing countries and elsewhere. We now are living with the consequences of that default in public policy that took place 8 or 10 years ago.

The question, therefore, beyond the immediate need to keep the system glued together—to put it quite inelegantly—is how to step up long-term lending to the LDCs for productive investment and how to keep the trading system at least as open as it is now—and hopefully even more open—over the course of the 1980's.

Posing the question in terms of the conflict between domestic needs and international needs is not a real or wise one. The tradeoff is not between domestic financing programs and international financing programs. The real trade-off is with defense expenditures because we are going to buy an awful lot more security and do a lot more to enhance U.S. interests by expanding the role of the IMF than what we are going to get from a heck of a lot of the current defense budget proposals.

Senator **Proxmire**. I just wonder whether we do occupy the same position where we should provide as high a proportion, so much more than any other country. And if other countries have provided something we did not provide, why it should have such a disastrous psychological effect.

I am sure many people would be very unhappy. It might be a very bad mistake. But it seems to me when we talk about psychological effects, we tend to get away from the hard, tough analysis that would tell us what happens if we think this through and recognize this is really a fairly limited amount of credit we are talking about, even for the economies of the countries we are talking about.

Mr. **Sewell**. I suppose that if it is that negligible a sum of money it will be easy to provide. But to stop being facetious, I would say, the impact of a quota increase is partly psychological, but psychological is often as real as real. The signals that are sent out by a country as large and as important as the United States are terribly important.

And there is no question that our share in these international institutions has diminished over a period of time. May I give you one example, not of the IMF but of foreign aid. Last year, total U.S. official development assistance was almost precisely equal—within a few hundred million dollars—to the official development assistance provided by Saudi Arabia. Yet the GNP of the two countries is somewhat different.

In many of these areas we have to put up our fair share both in terms of our size in the international economy and the importance of the international economy to the interests of the United States.

Senator **Proxmire**. I just wonder what would happen if a large lesser developed country, did not pay its debts. I recall when I was chairman of the Senate Banking Committee when both the New York City and the Chrysler loan guarantees were approved—I opposed both of them. Of course, the Congress and the committee favored both of them and went ahead with them.

I opposed them because I was convinced that neither New York City nor Chrysler would get into trouble. The banks in New York, there is no way they would let New York City go down. They had ample resources to take care of the city.

And I am sure that the banks that funded Chrysler might well have done the same. The terms would have been very tough, nobody would have been very happy but that would have been the result.

What happens if we pursue this further and if a large country in South America or elsewhere does go bankrupt, can you spell that out for us for a minute?

Mr. **Sewell**. I am not sure what you mean by go bankrupt.

Senator **Proxmire**. That is a bad term. Say they simply fail to pay, say they cannot do it.

Mr. **Sewell**. Over some longer run period of time, then just what would happen to countries such as Mexico, or Brazil, or Argentina?

Senator PROXMIRE. Yes.

Mr. SEWELL. Well, were one to see the financial collapse of Mexico, for an example, the ramifications to the United States, for instance, would be quite considerable. But I would like to say emphatically that that will not happen in the real world. Mexico is our third-largest export market. It has been one of our fastest growing export markets. The amount of American investment in Mexico is quite considerable. The amount of American private bank lending is considerable and therefore Mexico's collapse would reflect on the stability of particular international institutions.

If we think that Central America is causing us problems in terms of internal political debate about American policy, serious instability in Mexico would multiply that by several hundredfold. And of course the impact on migration to the United States from Mexicans legitimately seeking work would be quite considerable.

Now, that is a worst-possible case scenario which is probably better suited on the racks of a paperback stand in the drugstore than in a serious deliberation like this taking place here because Mexico is not going to collapse for a variety of reasons. What you would get, it seems to me, in a much more likely sense, is a sort of gradual disintegration, deterioration of the situation. And if many countries collapsed we would slip into a worldwide depression with considerable impact on the United States.

The seeming paradox here, as I have tried to point out in my testimony, is that there is now a two-way impact. It is quite true that recovery in the United States and the rest of the industrial countries is terribly important to the Third World. But as a result of the developments over the last several decades, the slow growth or no growth in the developing countries is going to have a considerable impact on any industry in the United States which depends to any extent on exports and, obviously, on our private banking system.

Take Caterpillar Tractor. Caterpillar—if my understanding is correct—has done about everything right in terms of efficiency and in terms of planning. A good part of Caterpillar's problem is that their world market has shrunk dramatically. Demand has slowed around the world because one of the first budget items cut are construction projects needing heavy equipment.

Senator PROXMIRE. At the same time, it just seems to me—maybe my economic philosophy is wrong—but I have the feeling that several years after World War I, Germany had a fantastic inflation. They cured that inflation in part by simply getting a new mark; by sharply reducing their expenditures; laid off tremendous numbers of people. The economy was in a shambles for a short time, then it recovered.

For the first time the cost of living went down by 8 percent. Employment went up, and they began a strong recovery.

Mr. SEWELL. I would defer to my colleagues whose economic history, I am sure, is much better than mine. My recollection is, though one would not want to take international economic policy——

Senator PROXMIRE. Of course, we do not want it.

Mr. SEWELL [continuing]. In the interwar period as the paragon of what can be achieved in the future. The political ramifications of economic instability within Germany, for German politics after 1933, were quite marked.

Senator **Mathias**. National Socialism went a little farther than just curing inflation.

Senator **Proxmire**. Well, that did not come in 1921, that came a lot later.

Mr. **Sewell**. But it grew from the whole heritage of what took place in the 1920's in Germany.

Senator **Proxmire**. I doubt if what was the result of that happened.

Senator **Mathias**. Let me interject here the thought that you set up the case of a defaulting nation as coming from the developing world. The developing world has no monopoly on the right to default, and it is conceivable that a European industrial nation might find itself in serious problems; is it not, Mr. Krause?

Mr. **Krause**. Well, I think in times of a world depression lots of things could happen. I think the instrument that a developed country might take to meet their immediate needs might be different than defaulting on their debts. It might be something like a competitive depreciation of their currency as a way out, even knowing when doing it that it may make conditions worse for its neighbors.

The developing countries however, I think, might go to the debt problem faster because that may be the cutting edge of what their problem is at that moment.

Senator **Proxmire**. Would that possibly force internal reforms and more realistic policies on the part of the country, or would it be all negative?

Mr. **Krause**. Unlike the 1920's when we had country-to-country debts, the developing countries now owe a lot to private bankers, and they are forced to get whatever redress they can in the courts. That would mean for a developing country, any asset that existed abroad would be attached and attachable. That means any trade they would do—indeed almost all of their trade—would come to a standstill because you would have a hard time passing title to a new purchaser because every bank would be out to get that asset.

I think it would really isolate the country from the international system. And I cannot see, under those conditions, that you would get good reforms in the country. Indeed, I think you would get radicals.

Mr. **Sewell**. Can I interject for a minute, Senator? I think there is a fairly clear consensus that over the 1970's a large number of developing countries—there are obviously some exceptions among more than a hundred countries—have made some very difficult choices of adjustment.

What Mexico is trying to do now—and we can all hope they succeed—is tough politically—letting food prices rise; cutting off transfer of funds overseas, and a variety of other measures that are politically unpopular and therefore tough for any Mexican Government.

The additional problem, it seems to me, is not only depression, but the kind of effects that John Mellor described so well. Countries having now learned to emphasize market forces and adopted an outward economic orientation, will now be forced to withdraw inward. And the implosion effect of such choices on the world economy could be very great.

By the way, I hope that my worst-case scenario for Mexico is treated as such. I think that if commodity prices were at a decent level; if there was a decent amount of growth in the United States, and if there was reasonable demand for oil, Mexico's situation would look much different than it does now.

Senator **Mathias**. Going back to this question of market orientation, we have been advising developing countries for some time to withdraw political interference from their marketplaces and depend on market orientation.

Now, with the 30-year record low in commodity prices those countries that depend on one or two basic staples are in desperate condition. So, the market orientation has proven to be a very expensive policy for them—less so to countries that have a more balanced kind of economy.

Is there any middle ground that we ought to explore as an amendment to our advice to these people in the future?

Mr. **Krause**. Senator, I think if you look at the developing countries that have followed market-oriented policies, they rarely get dependent on a single commodity.

Indeed, what we have discovered in countries like Thailand is that within the agricultural sector it becomes quite diversified when the market signals are permitted to feed through and you get a variety of product.

The monoculture economies are often the ones where market policies are least utilized. I think that is almost an inevitable consequence of too much interference.

So, I do not think that there is a conflict in the advice we are giving them. Whether we should in fact go farther and when we see a monoculture economy suggest even more things for them to do, is something we ought to think about.

Senator **Mathias**. What about development advice in general? We have had certain theories on fashions in development advice over the last generation. Is there anything you would think that we should do differently in the future? Mr. Mellor?

Mr. **Mellor**. I would like to land on that one fairly hard and perhaps disagree for once with one of my colleagues here.

I think it is a little simplistic to say that we can divide the success stories amongst developing countries from the failures simply on the basis of orientation toward the market. I think there is a much more basic factor involved here and that is the level of institutional development, and behind that is the extent of training of people, all the way to high levels of training.

What we did very effectively—the United States I am talking about here—in the 1950's and early 1960's was to make a tremendous contribution to the development of trained people, particularly at higher levels, developing universities, colleges of agriculture, and so on, particularly in Asian countries.

It has taken 15, 20, 25 years for that to show up. But it is showing up very well now in Asia and explains in my view a great deal of the success there.

And incidentally, with the large numbers of trained people, the market forces work much better because you can have thousands and thousands of private firms with educated, trained people with technical knowledge and so on in them.

It is very difficult to do that when you have a handful of trained people. You have to have them mostly in the Government in order to keep any kind of political stability. You find the rest of your economy just does not have the trained people to make it operate in a market-oriented way.

When we begin to move heavily into foreign assistance in Africa, particularly as we moved well into the 1960's, this business of training people—particularly at higher levels—was somewhat out of fashion. This was talked of as building urban elites and so on, and we did much less in Africa in contributing to developing bodies of trained people in the effective institutions in which they can operate.

That, in my view, has set back African development by a decade or possibly more. I hope very much that in foreign assistance we will get back into that much more heavily.

And incidentally, I believe that our AID as presently constituted is getting back into that more heavily at the present time. I think that is quite consistent with a market orientation and will facilitate it considerably.

So, I think in foreign assistance with the least developed countries, the ones that are not making progress, we need to give more attention to this business of building their capacities to do things. Once they get those capacities, then facilitating commercial-financial flows, improving trade facilities, and so on, will become very effective. I think this is a lesson that is very important in the African context.

Senator **Mathias**. What you are suggesting is that they should not graduate from concessional assistance to commercial borrowing until they reach a generally recognized level. That we should not push them too hard and too fast.

Mr. **Mellor**. Yes, that is true.

Senator **Mathias**. Now, one final question that I have. Do you have any?

Senator **Proxmire**. No.

Senator **Mathias**. I have just one last question.

Secretary Blumenthal this morning noted that for the first time in modern history the population growth rate was higher than the gross national product growth rate in a number of developing countries. Even if it hangs around the same level, you have a condition of stagnation in terms of a lot of individual people.

What do you foresee as the result on social and political stability if the growth rates stagnate during the 1980's?

Mr. **Sewell**. Let me respond by saying that both the academic community and the policy research community have lost about a decade on understanding that issue. The study of political development got severely discredited because of our involvement in Vietnam. We have disinvested in a lot of our capacity for area research because of the cutback in Federal and foundation funding.

The conventional wisdom is that as you get further economic cutbacks, you will get greater political instability. In a general sense, I suppose that is true. But one only has to walk outside this room and look North on North Capitol Street where the unemployment rate for black young people is close to 50 percent and notice the lack of political instability in this country. Your question therefore is a difficult one to answer.

What you will undoubtedly get in the first place is an increase in human misery and a decrease in human well-being. Under a more adverse set of circumstances, I would not be surprised to see much slower increases in life expectancy, worsening in infant mortality, and so on and so forth.

Where you will get political instability and where you will not is very difficult to predict. There is a strong case to be made for countries at very low levels of development and with strong traditional societies; with those you get relatively little unstability. It is only when the process of modernization begins and people's expectations change that you get growing amounts of political instability.

One key element may be the expectation that you or your children are going to be better off over a period of time. That is a very strong element for stability.

I think this may be the case in Mexico. Mexicans, by and large, have felt over a long period of time that they were doing better and their kids also would do better. Rightly or wrongly, that is the way they feel. If that perception changes, you may see more political unrest in Mexico and also in other countries.

Senator **Mathias**. Mr. Mellor, do you have anything to add to that?

Mr. **Mellor**. I am a little puzzled with the statement. I think as far as the Third World is concerned, I do not suppose it is true that per capita income, GNP, is growing less rapidly than population. That means per capita incomes are declining.

I was just running it through my head, I do not think that is true of any Asian country at the present time. They all have positive per capita income growth rates. So, GNP is growing faster than population. That must be true of most of Latin America.

There is probably a good share of Africa that is hanging on the edge of that at the moment.

Mr. **Sewell**. But the total population is smaller.

Mr. **Mellor**. If that is true on a global basis. It must heavily be because of the virtually zero per capita income, of GNP growth rate, through much of the Western World that we have at the present time.

Senator **Mathias**. That would be the happiest reaction to it, if you could disprove the statement. That would resolve the problem.

Senator **Proxmire**. Could I ask Mr. Krause just one more question?

Senator **Mathias**. Certainly, go ahead.

Senator **Proxmire**. Mr Krause, many people may be worried about the fact that the IMF lends its money at 6.6 percent. That seems to be a pretty happy rate and one that would make a lot of borrowers in this country envious, even now with the very sharp drop in interest rates. Most businessmen, small businessmen, borrow at a much higher rate. I realize we are lending to a country in that case.

What would you think of efforts on our part to try to change that rate, increase it to something near the level at which the U.S.

Federal Government and other governments have to borrow long term?

Mr. **Krause**. That would not disturb me, Senator. I would not be surprised, however, if the average, sort of weighted average, of government borrowing rate—short term—was not pretty close to 6.6 percent. And the IMF is a short-term lending, not a long-term lending institution.

Senator **Proxmire**. Six-point-six? Where do you get rates like that?

Mr. **Krause**. Rates are below it in Switzerland, and below it in Japan for the short-term end of the market. I would not be surprised if it is below in Germany; I would have to check. Those are pretty big countries.

Senator **Proxmire**: They are not below it here.

Mr. **Krause**. The bill is probably 7.8.

Senator **Proxmire**. Well, it is pretty close to eight.

Mr. **Krause**. Yes.

Senator **Mathias**. Maybe we had better adjourn so that Senator Proxmire can head for the airport.

[Laughter.]

Senator **Proxmire**. Switzerland, here we come.

Senator **Mathias**. Gentlemen, you have been extremely helpful. We appreciate your testimony, the effort you put in the statements. This will be a very valuable addition to the record. We appreciate your being here with us this afternoon.

The subcommittee will stand in recess until 10 a.m. on January 19.

[Whereupon, at 3:45 p.m. the subcommittee adjourned, to reconvene at 10 a.m., Wednesday, January 19, 1983.]

GLOBAL ECONOMIC OUTLOOK

WEDNESDAY, JANUARY 19, 1983

UNITED STATES SENATE,
SUBCOMMITTEE ON INTERNATIONAL ECONOMIC POLICY
OF THE COMMITTEE ON FOREIGN RELATIONS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room SD-419 (4221 DSOB), Hon. Charles McC. Mathias, Jr. (chairman of the subcommittee) presiding.

Present: Senator Mathias.

Also present: Senators Warner and Proxmire.

Senator MATHIAS. The subcommittee will come to order.

We are meeting today for the third in our series of hearings on stresses and strains in the international financial system. We will be focusing this morning on the issue of global debt.

In recent years, the level of indebtedness of a number of countries has expanded dramatically. The Third World external debt has grown from approximately $100 billion in 1973 to over $600 billion at the end of 1982. This expansion took place at a time of high inflation and relatively low real interest rates.

It appeared to make sound economic sense in the 1970's for commercial banks to extend financing to Eastern European and lesser developed nations, and for the debtor nations to enlarge their indebtedness. The premise on which this debt was contracted disappeared when real interest rates soared; when the West slipped into a prolonged recession, and when commodity prices slid to a 30-year low.

Country after country went to their bankers with requests for rescheduling new loans. Poland, Mexico, and Brazil have only been the most publicized of a long list of countries facing debt servicing problems.

The dilemma we face is not just an economic one but also one of general confidence in our financial institutions and economic system. In strictly economic terms it is possible to isolate those factors which could improve the lot of debtor nations: An end to the recession in the West; a decline in interest rates; rising commodity prices.

But the issue of confidence in the system poses a more difficult problem. In recent months, the international financial community has had to respond to crises in a number of debtor countries. Literally hundreds of commercial banks have been participants in the economic problems of Mexico. Brazil, and other debtor nations.

These banks are widely perceived to stand helplessly exposed to economic forces over which they have little control.

At the same time, the tough medicine in the form of IMF conditionality being administered to Mexico and other countries is raising concerns—at least in some quarters—that the political price of economic reform may be too much for some nations to pay.

There are no simple answers to these questions. The international financial system is so interrelated that actions taken in one part inevitably ripple through the whole system.

We must, it seems to me, tread very cautiously as we determine how best to proceed, not just in responding to individual financial emergencies but also to the more general strains in the global financial system.

I was pleased, however, this morning to receive a telephone call from Mr. Regan, the Secretary of the Treasury, commenting on the statement issued yesterday in Paris after the meeting of the G-10 Ministerial. I think that the strong endorsement given by this gathering to the need for additional resources for the IMF will send a message of some hope to those countries around the world which are experiencing economic difficulties.

I believe from what he told me, that there will be the resources available to the IMF to cope with the emergency problems that could possibly arise.

Now, to help us in grappling with the understanding of this situation we have with us today two very distinguished panels, Hon. John G. Heimann, cochairman of Warburg, Paribas, Becker. Mr. Rimmer de Vries, senior vice president and chief international economist of Morgan Guaranty, and Mr. Robert Solomon, a guest scholar at Brookings. They will constitute a first panel.

It will be followed by a second panel which will consist of Mr. Felix G. Rohatyn, a senior partner of Lazard Freres and Mr. William Cline, senior fellow at the Institute for International Economics.

We are very pleased that all of them can be with us today.

Before we ask the first panel to begin, let me turn to Senator Proxmire who is such a valuable Member of the Senate and of this hearing.

Senator **Proxmire**. Thank you, Mr. Chairman.

Once again I want to thank you for your generosity in inviting me to attend a Foreign Relations Subcommittee hearing. I am not a member of the Foreign Relations Committee. As you know, I have been on the Banking Committee for many years and I am very interested in this, too. You are very gracious to extend an invitation to us on the Banking Committee.

Mr. Chairman, I just want to call attention for the record to an article that appeared under the signature of Charles McC. Mathias, Jr., yesterday in the Washington Post. The title was, "The World's Problems Are Our Problems."

I particulary want to call the attention of the panel—maybe for their consideration and comments when they finish delivering their statements—to the principal points you make here, or some of the principal points.

Let me read them because that part of its is very brief. You say, "We must give careful thought to three problem areas in particular. First, we need a far more accurate and current data base with respect to levels of indebtedness and the extent of the lines of credit available to major foreign borrowers. We cannot go on being repeatedly surprised by major borrowing nations unable to service their debts."

As I understand it, we have a rather accurate data base now as far as American banks are concerned. There is a publication by the Federal Reserve Board that comes out regularly. However, that is not up to date and of course that is only American banks. We do not have a data base with regard to the loans made by foreign banks, which may be more important in many cases than the American banks.

Certainly, that kind of comprehensive data is what we need. Securing that may be difficult but it is certainly something we need to do, and I understand there is some effort in that direction already.

Second you say, "we need to consider whether gaps exist in the present institutional framework between the World Bank, which engages in long-term project lending and the International Monetary Fund, which provides short-term balance-of-payment support. It is not clear that institutionally we are fully prepared to deal with either crisis situations or long-term adjustment problems."

That raises the question that—I think you are absolutely right—we have concentrated very heavily on the IMF and it needs attention. But the World Bank may be even more fundamental and that may require enormous infusions of capital if it is going to meet the kind of international problem we face. I am delighted you call attention to that.

Finally, you say, "we need to take a hard look at the existing regime of flexible exchange rates. The rapid and extreme fluctuations in exchange rates are contributing to dangerous distortions in the global economy."

We certainly need to take a look at that, and I think it is going to be extraordinarily difficult for us to find ways of coping with that unless we go to maybe a different system or think carefully about returning to a system of fixed exchange rates, or something of the kind.

At any rate, I want to commend you, Mr. Chairman, not only on these hearings but on this excellent article and putting your finger on the most difficult problems that face us in such a useful way.

If you would permit it, I would like to have the article printed in the record.

Senator **MATHIAS**. Without objection. [Laughter.]

[The article referred to follows:]

[From the Washington Post, Jan. 18, 1983]

THE WORLD'S PROBLEMS ARE OUR PROBLEMS

(By Charles McC. Mathias, Jr.)

We are not the only ones facing economic hardship. The world economy is in serious trouble. The evidence is everywhere, in massive national debts, rising unemployment, declining trade volume and idle factories.

Yet, some Americans retain a curious illusion that we can separate ourselves from the global economy. We hear a lot of talk these days in support of protectionist legislation and in opposition to providing additional resources to multilateral institutions such as the International Monetary Fund.

It is dangerous talk. We will only hurt ourselves if we ignore the stake we have in a global economic renewal.

The facts are stark. Exports as a share of the U.S. GNP have doubled in the last decade. We now export roughly 40 percent of our total agricultural production. One out of every eight U.S. manufacturing jobs produces for export. Almost 20 percent of our industrial production is exported.

We are in trouble when Brazil and Mexico face economic hardship, because they are big traditional users of U.S. goods and services. When they reduce their imports as part of an economic austerity program, it is our exports that are being cut.

The banks on Main Street America are in trouble when debtor nations can't service their loans. Across the United States, there are hundreds of banks with loans to financially troubled foreign borrowers. They face losses that could threaten their survival, yet it is beyond the capacities of the managers of these financial institutions to solve their problems. Solutions may exist, but they aren't to be found in the board rooms of these banks.

The challenge we face, therefore, is not to figure out how we can say no to the IMF and lock out the Japanese but how, in cooperation with our economic partners, we can restore the health of the international economy.

It won't be easy. The industrial West is gripped by a severe recession. The OECD estimates that between 1981 and 1984 unemployment in member countries will rise from 25 to almost 35 million. Between 1979 and August 1982, commodity prices fell by approximately 30 percent. They are, at present, at their lowest level in a generation, reflecting greatly reduced global demand for primary exports.

The less-developed countries (LDCs) are laboring under massive external debts (over $500 billion in 1982) contracted largely in the last decade at a time of relatively low real interest rates. They now face high real interest costs and greatly reduced demand for their exports. More and more countries are having to go to their bankers for help, with Mexico and Brazil at the head of the line.

Their problem has been described as one of liquidity, not solvency. Major borrowers are retrenching, but if that process of retrenchment is not to be politically and economically catastrophic they need fresh financial resources.

The international financial community has, in recent months, had to leap repeatedly to the rescue of financially troubled borrowers, most notably Mexico in August and Brazil in December.

But we cannot go on applying Band-Aids to problem countries. A comprehensive approach to these global economic problems is called for. Additional resources for the IMF may be part of the solution, but they are not the whole solution.

We must give careful thought to three problem areas in particular. First, we need a far more accurate and current data base with respect to levels of indebtedness and the extent of the lines of credit available to major foreign borrowers. We cannot go on being repeatedly surprised by major borrowing nations unable to service their debts.

Second, we need to consider whether gaps exist in the present institutional framework between the World Bank, which engages in long-term project lending, and the IMF, which provides short-term balance-of-payments support. It is not clear that institutionally we are fully prepared to deal with either crisis situations or long-term adjustment problems.

Finally, we need to take a hard look at the existing regime of flexible exchange rates. The rapid and extreme fluctuations in exchange rates are contributing to dangerous distortions in the global economy.

The Senate Foreign Relations Committee is holding hearings this month and next on stresses and strains in the global economy. We are hearing from a number of former secretaries of the Treasury, together with other expert witnesses on the nature of our economic problems and the avenues for addressing them.

But our need is not just economic, it is fundamentally political.

A national consensus must evolve in this country around the proposition that cooperation not confrontation is required if the world economy is to be rescued from its present unhappy state.

This means that the unemployed worker in Baltimore, Chicago, or even Detroit, needs to see that his hope for a better future may lie in the restored economic health of countries as close as Mexico or as far away as Romania. That, in fact, their problems are our problems.

One of the major challenges the 98th Congress will face is to foster just such a consensus. Without it, we risk deepening our already very serious global economic difficulties. With it we may be able to move to a better economic future for ourselves and for other nations around the world.

Senator **Mathias**. I thank the Senator from Wisconsin for his charitable comments here this morning.

Before the panel begins, I also want to take this opportunty of welcoming two visitors this morning, Members of the Parliament of France. Mr. Martin Malvy and Mr. Christian L'Aurissergues are Members of the National Assembly of France who are visiting the Congress and who, I hope, will be less bewildered than the Members of Congress by these proceedings. We are happy to have you.

Gentlemen, do you have any order in which you would like to proceed? Mr. Heimann?

Mr. **Heimann**. Let Mr. de Vries go first.

Senator **Mathias**. Mr. de Vries, do you want to start?

STATEMENT OF RIMMER de VRIES, SENIOR VICE PRESIDENT AND CHIEF INTERNATIONAL ECONOMIST, MORGAN GUARANTY TRUST, NEW YORK, N.Y.

Mr. **de Vries**. I am Rimmer de Vries. I am senior vice president of Morgan Guaranty. I have a presentation which is much too long to read. So, I ask you to print it in the record.

Senator **Mathias**. Let me say that, without objection, all the statements will appear in full in the record and you can feel free to summarize them.

Mr. **de Vries**. I shall in the 10 minutes I have at my disposal go to the key parts of this paper. I described in the first 10 or 11 pages the history of the emergence of the international debt problem and want to focus only on the point when things went wrong.

We have done some calculations, and I mention this because it is the main point of my testimony: That it is the world economic crisis—the excessively high interest rates and the prolonged change in the terms of trade among the industrial nations and the less developed nations, and of course, the lack of growth in the industrial world—that made the debt problem a global problem.

Had there been less change in the terms of trade and real interest rates not as high for so long, we might have had some individual countries with problems but it would not have turned into a global problem.

I have the statistics in the statement where it is all graphically presented. However, I want to stress that the key to the global debt problem is the widespread economic debacle.

I sometimes say, you cannot protect yourself against death. When the world economy goes flat for that long and it in a sense dies, there is very little you can do about it to protect yourself.

So, this being the lead-in, I have presented prepared remarks, a blueprint for reconstruction and, as is Senator Mathias, I am very happy to say that indeed I do think it is emerging.

I presented this in October in "World Financial Markets" and it had basically four main parts to it:

One, there must be a significant adjustment in the less-developed countries to cut the current account deficits.

Two, the banks must stay in with continued lending—albeit at a lower rate of growth—but stay in, both in the short- and in the medium-term area.

Three, the Fund and other international institutions must be involved intensively in assisting and monitoring the international adjustment process.

Four, and most important, with inflation down, monetary and fiscal policies in industrial countries should be cautiously retuned to make moderate economic recovery a more certain prospect.

All of those four factors are very important, and there has to be a judicious blend between adjustment and financing.

What I have done since October is put some numbers together and developed some reasonable scenarios which I presented in detail in this paper. I would like to suggest you turn to table 5 in my statement which summarizes the main assumptions and the main consequences of these scenarios.

Scenario A and scenario C I want to call attention to. I find it interesting that if we pursue a course whereby the industrial countries aim at a modest growth, not a big growth but modest, you can see it in the top line—a 1½ percent growth this year would seem to be in the making. There is very little we can do to change the course of this year—fairly little— but assume that we have a 3-percent rate of growth in all industrial countries, not only in the United States but in all of them, in 1984 and 1985, and that LIBOR, the key interest rate, the 6-month Eurodollar rate, which is around 9 percent this year, stays at 9 percent next year, and rises no more than to 10 percent, say, in 1985.

This would produce a modest turnaround in the terms of trade of the LDC's. So, you have some recovery and some terms of trade reversal—not completely but at least 60 to 70 percent reversal of the terms of trade of the borrowing countries to permit them to also have a modest upturn in their export volume.

And at the same time—and that is the second part of the scenario—the LDC's do adjust. They keep the growth of import volume down by keeping real GNP growth in their countries down.

And if this is pursued, you will see that the current account balance—the key factor—will come down in this group of countries. I will be focusing on 21 major countries such as Mexico, Brazil, Korea, and the Philippines, the main countries of the less developed world.

Their current account deficit will go down from $64 billion to $27 billion in 1985. And this will restore the current account balance as a percent of exports, a key ratio, from 23 percent to about 6 percent; a very drastic reversal.

The total debt of these countries will grow in that case from about $500 billion at the end of 1982, to about $625 billion in 1985.

Now, if I assume that the banks will continue to expand their loans—not just United States but all the banks—by about 7 percent per annum—which is at the moment incorporated in the various agreements we have with Mexico and Brazil—they will finance of this $125 billion international debt growth about $70 billion, which is a reasonable amount. Then, what is left over is between $50 billion and $60 billion which has to be financed by trade flows, trade credits, and by the IMF, World Bank, and other international institutions.

It is hard to dissect all of these in these projections, but a reasonable amount, maybe half, may be trade financing. It may be not quite as much but certainly about $20 billion. Then you have an amount of about $30 billion that may have to be financed by the international organization and principally by the Fund, which is not an unreasonable number.

So, I am shooting for scenario A as a blueprint from which we should be working. In scenario C you do not have much economic growth in the industrial countries and you have less adjustment in the LDC's. The figures show very clearly that in this situation it is impossible to solve the debt problem.

In scenario C the current account balance of these countries will grow. Instead of going down, say, from $64 billion to $27 billion in scenario A, it will rise from $64 billion to $91 billion. The debt would go from $500 billion to $750 billion, which would be unfinancable by the banks or by international institutions.

So, we have no choice. If we want to really solve the debt problem through the normal market forces in an international cooperative way, we have to have a plan and order whereby we will have a mixture of modest growth and some adjustment of the LDC's. The banks will stay in, increasing their loans at a modest rate of 7 percent, and there must be additional money infusion by the international organizations.

I am very happy to say that I already feel that this is in the making. There is a lot of adjustment going on in the countries of Latin America. I think we are encouraged—more than encouraged. The banks are staying in, the Fund is very active, and we are all surprised how rapidly the mood of this administration has changed—in the sense of calling for some modest turning of policies in England, Germany, and Japan.

So, I feel we are on the road for scenario A. I have listed a number of conclusions and recommendations in my paper.

I am convinced that the situation is manageable. I think the blueprint is realistic. It is within reach. It will take time for restoration of creditworthiness. I would say maybe 3 years. For some countries it will be less, for some it may be a little longer. There are going to be setbacks. There are going to be surprises. There will be some slippage in some cases and it will take some time.

I stress a very important point, which I have mentioned a number of times in this paper as well: We are not presenting this plan for anyone's particular benefit. It is not for the benefit of the LDC's or for the banks. It is to the benefit of the world. You cannot solve the debt problem without a recovery in the industrial nations. But you cannot get a really good recovery going in the industrial nations unless you solve the debt problem because at the moment between 30 and 40 percent of industrial country exports, including the United States, go to less developed countries.

When the problems of Mexico started in August, I reminded people that Mexico is our third largest exporter. A lot of people did not know this.

Mr. SOLOMON. Third-largest importer.

Mr. de Vries. OK, Mexico is the third largest trading partner of the United States. [Laughter.]

After Japan and Canada.

With the credit experience, I think you will find that although banks have to stay in at this stage, there will be less growth in bank lending over time. Some of the regional banks eventually will drop out, as they may opt to go back to their regional business.

So, I think the new expanded IMF money, which is now being considered and is referred to in the paper, is sufficient in the context of my scenario A. However, it is absolutely necessary. The pool of uncommitted money in the Fund is rapidly being depleted. The Fund has about $20 billion of liquid resources or, either what they call usable currencies, plus some $10 billion credit lines. About $25 billion is now being committed. So, for them to keep the momentum of lending over the next few years, the IMF need these resources.

I have a paragraph on the World Bank which I call, the IMF's half-forgotten twin. I believe the World Bank should play a more important role. In the past the World Bank became more and more directed to IDA-type loans because the international institutions, in their optimistic expectations about the leading LCDs, believed that these countries were ready to go to the bond markets to tap long-term funds there.

Well, whatever chance there was, it certainly has been delayed and postponed for some time. These countries need long-term money. One important source for this should be the World Bank. Now that the plan for the new money for the IMF is on its way, we should not forget the plan for doubling the World Bank's capital. The World Bank is an important institution in the solution of the debt problem, and is more needed than ever in the next decade.

I have suggestions to strengthen the international financial system. One is the BIS. I will not go into a great deal of detail but I think there are ways in which we might be able to strengthen the function of the BIS itself. I suggest we may want to review or reconsider our past hesitancy to become a member. That is a question that has been with us for 50 years, since 1930. It has been discussed many times but we never joined. But our membership could have a useful function to strengthen the role of the BIS.

The question that is of course on all our minds is, how can we avoid surges in excessive concentration of credit? I have a number of suggestions; namely, in the field of information.

I do think we have a lot of information. We have more information, I think, than Senator Proxmire just suggested. We do have, through the BIS, a lot of debt information not only about American banks claims on foreign countries, but also about German and all the other banks, all the major banks.

But some of that information is dated, it may be 6 months old. And one is always wondering whether it is complete, not only as regards the liabilities to countries but also about the countries' assets. Once the credit problems arise and you start looking into the assets, you will find out that not all the assets are there, or that they are not always available in liquid form. When crises come, there are always surprises—debts are underestimated, assets are overestimated.

So, this information is available or should become available to the IMF, the BIS, and the central banks. It has been a very sensitive area in the past but I find there should be more coordination; there should be more exchange of information, discussion, among the IMF, BIS, central banks, and the commercial banks in the world.

There has been too much of a standoff behind the shroud of confidentiality. I find there has to be more and harder work to exchange evaluations and information.

In this connection there is a positive development now underway in the private sector, the establishment of a new institute which I am sure Mr. Ogden will discuss next week. It is intended to improve the quality of timely country financial data to be made available to the banks.

In conclusion, I think it may be helpful to recall that we have seen similar problems in the past. In 1974, for example, many feared that the quadrupling of the world price of oil had created a balance-of-payments problem so severe that it was going to bring on global financial collapse. Yet, we overcame that problem with calm reason and international cooperation. We can do it again.

We have already moved back from the precipice. Although there are no guarantees, a solution to the world debt problem is in reach. Bank lending must continue to support LDC adjustment efforts. Industrial countries must develop policies that will sustain economic recovery. The IMF and the World Bank must receive strong support.

These two institutions were created at the end of World War II specifically to prevent a recurrence of the kind of inward-looking policies that plunged the world into a depression in the 1930's.

Today, at a time when there are dangerous parallels with the conditions of 50 years ago, the IMF and the World Bank have never been more needed. We must not pull back from our international responsibilities, nor should we seem to encourage other countries to pull back from theirs. It is in the self-interest of all parties that each does its part.

Thank you.

[Mr. de Vries' prepared statement follows:]

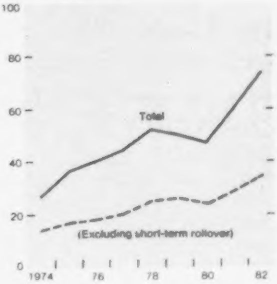
World Financial Markets

Morgan Guaranty Trust Company of New York

February 1983

Global debt: assessment and prescriptions, 1
  Origins and magnitude of the LDC debt problem, 2
  Blueprint for reconstruction, 6
  Conclusions and recommendations, 11
Statistical appendix, 15

21 Major LDC borrowers
Debt service ratios
debt service equals interest payments, amortization, plus rollover of short-term debt; as percent of exports of goods and services



Global debt: assessment and prescriptions*

The issue of global debt has come to the fore at a time of economic and financial strain, which is unparalleled in the post-World War II era and looks, in some respects, frighteningly reminiscent of the Great Depression. You will recall that among the factors that severely aggravated the economic contraction of the 1930s were sharp declines in the volume of world trade and the prices of internationally traded commodities. These depressed the economies and strained the debt servicing capacities of the less developed countries, especially those of Latin America. Contraction of international financial markets, involving both short- and long-term credit, ultimately led to widespread defaults and even debt repudiation, exacerbating the slump in world economic activity.

Today, we are again confronted with prolonged worldwide recession, characterized by growing unemployment, spreading protectionism, several competitive devaluations, sharp declines in commodity prices, and a contraction in the volume of world trade. Moreover, a growing number of countries are unable to meet their external debt servicing obligations on schedule. The manner in which the international community responds — with inward-looking policies or with cooperation and coordination — will ultimately determine whether the present situation deteriorates or improves. This, in turn, will have direct bearing on the chances for sustained economic recovery in the United States.

The title of this hearing, "Global Debt," is well chosen. Until recently, debt servicing difficulties and reschedulings were confined to a few isolated cases, involving countries that had borrowed relatively small amounts from commercial banks. For example, in the 1970s the two largest reschedulings that involved debts owed to banks were by Turkey and Peru, each of which had about $3½-$4 billion of outstanding bank debt at the time; in neither instance were there damaging spillover effects on other countries. By contrast, since 1981 the problems of Poland have affected bank lending to all of Eastern Europe, and this past year the debt difficulties of Mexico and Argentina have had an impact on all of Latin America.

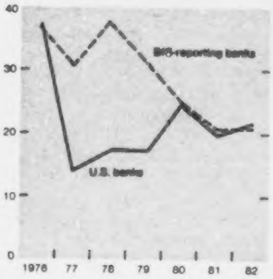
More than 25 countries around the

---

*Statement by Rimmer de Vries, Senior Vice President, Morgan Guaranty Trust Company, before the Subcommittee on International Economic Policy of the Senate Foreign Relations Committee, Washington, D.C., January 19, 1983.

Growth of bank lending to 21 major LDC borrowers

annual percent change in banks' claims, in dollar terms



world are now in arrears, in the process of rescheduling, or have already rescheduled portions of their bank debt. Their combined outstanding bank debt is estimated to be more than $200 billion — nearly half of the total debt LDCs and the Eastern bloc owe to commercial banks. Latin American countries account for about 80% of the bank debt of these countries. An additional 15 countries with bank debts totaling nearly $80 billion face serious balance of payments difficulties that could lead to arrearages or reschedulings later this year if the current negative international lending environment persists.

In my remarks today I intend to focus on the origins and magnitude of the debt problem, present a blueprint for reconstruction, and make several specific recommendations for strengthening the international financial system.

Origins and magnitude of the LDC debt problem

The present surge in international lending to LDCs is less than a decade old. Until the early 1970s, the LDCs had only limited access to international financial markets and instead had to rely on official sources to supply the bulk of their external financing. As of 1971, two-thirds of the LDCs' external debt was owed to official sources; the remaining third consisted of debt owed to suppliers, as well as to banks. In fact, comprehensive data covering loans by banks in the BIS-reporting area or by U.S. banks, including their foreign branches, were not even compiled until the mid-1970s. Bank lending to LDCs in the 1960s was largely confined to short-term trade financing, a few term loans to governments extended mainly in conjunction with IMF stabilization programs and often collateralized with gold, and a modest amount of project-related loans, frequently guaranteed by third parties.

During the 1970s, several developments turned banks into the predominant suppliers of funds to medium- and high-income LDCs. One factor was the emerging growth and investment opportunities in a number of developing countries whose economies began to open up and take off in the second half of the 1960s. During the past two decades, the LDCs' aggregate real output rose by 5½% annually, well above the 3%-4% per annum growth in the industrial countries. Many newly industrializing countries, such as Mexico, Brazil, and Korea, achieved growth rates well above the LDC average by inviting foreign investment and adopting outward-looking development strategies. With official assistance failing to keep pace with their growing financing requirements, they and other "aid graduates" turned to banks for loans to sustain their high growth rates and development programs. The emphasis in international lending during this period increasingly shifted from trade financing to project and balance of payments financing.

It is interesting to recall that the United States passed through a similar stage of development in the late 1800s. For many years between 1870 and 1890, this country ran sizable current account deficits, averaging close to 25% of exports of goods and services. During these two decades, it accumulated a large external debt, which averaged over 300% of exports in the last five years of this period. Moreover, interest payments on these debts ranged between 10% and 15% of exports. These ratios were well above those recorded by most LDCs during the past two decades.

The big surge in bank lending to LDCs began in 1974-75 in the aftermath of the first oil shock, when higher oil prices and ensuing world

BEST AVAILABLE COPY

Table 1

External debt owed to banks by 21 major LDC borrowers

end-June, 1982, in billions of dollars

	BIS-reporting banks	U.S. banks	
		All	9 large
Latin America			
Argentina	25.3	8.8	5.6
Brazil	55.3	20.5	12.3
Chile	11.8	6.1	3.3
Colombia	5.5	3.0	2.1
Ecuador	4.7	2.2	1.3
Mexico	64.4	25.2	13.6
Peru	5.2	2.3	1.3
Venezuela	27.2	10.7	7.1
Subtotal	199.4	78.9	46.7
Asia			
Indonesia	8.2	2.4	1.9
Korea	20.0	9.2	5.1
Malaysia	5.3	1.3	1.0
Philippines	11.4	5.3	3.7
Taiwan	6.4	4.4	2.7
Thailand	4.8	1.7	1.0
Subtotal	36.8	24.3	15.4
Middle East and Africa			
Algeria	7.7	1.2	.8
Egypt	5.4	1.5	1.0
Israel	6.1	2.6	1.4
Ivory Coast	3.2	.5	.4
Morocco	3.7	.9	.7
Nigeria	6.7	1.2	.9
Turkey	4.0	1.4	.9
Subtotal	36.8	9.2	6.2
Total of 21 LDCs	292.3	112.5	68.3
Total for all LDCs (excluding offshore banking centers)	347.5	125.5	77.7
21 LDCs as % of all LDCs	84	90	88

recession quadrupled the current account deficit of non-oil LDCs, from about $11 billion in 1973 to over $45 billion in 1975. For banks in the United States, such lending was facilitated by the removal of controls on capital outflows at the beginning of 1974.

This lending was encouraged by governments of the industrial countries. They were concerned that the OPEC current account surplus, which jumped from $7 billion in 1973 to $68 billion in 1974, would continue indefinitely at very high levels because of perceived limits on OPEC's "absorptive capacity." Banks, in which OPEC members placed a large portion of their surplus, were encouraged to recycle these funds to mitigate the higher oil prices' recessionary impact on the world economy.

In addition, IMF resources were boosted in 1974 and 1975 through the first and second oil facilities, which together totaled $9 billion, and later through the Supplementary Financing Facility, which added another $10 billion. The intent was to concentrate official assistance on those developing countries most seriously affected by higher oil prices and shortages of food and fertilizer, although such countries as Britain and Italy were also significant borrowers from the IMF oil facilities.

From the mid-1970s to the onset of the second oil shock in 1979, outstanding bank loans to 21 principal LDC borrowers[*] — each of which had bank debt of $3 billion or more by 1982 and which together accounted for nearly 85% of the bank debt of all LDCs (see Table 1) — grew at an average annual rate in excess of 30%. Credit to this same group extended by U.S. banks and their foreign branches increased at an average annual rate of 21% (see chart).

The rapid increase in loans to LDCs proved highly successful in terms of moderating the adverse consequences of higher oil prices for world economic growth. Economic expansion among the major LDC borrowers was sustained at a 5½% annual rate in 1974-75, because financing was available for their growing imports. This, in turn, helped growth in industrial countries, which were able to continue expanding their exports to developing countries. For example, U.S. exports to those countries increased over the period, at an annual rate of about 30% — nearly twice as fast as the growth of U.S. exports to industrial countries. By the second half of 1975, a strong recovery was under way in the United States, and recovery in other industrial countries followed. The 1974-75 recession in industrial countries was, thus, relatively short-lived. OECD real GNP growth averaged over 3½% annually in the remainder of the 1970s.

Current account imbalances narrowed as the world economic environment turned more favorable. The combination of rapid growth in OPEC imports and a 20% fall in real oil prices led to the disappearance of the OPEC surplus by 1978. Importantly, part of the reduction of the OPEC surplus accrued to the benefit of non-oil developing countries, whose current account deficits narrowed.

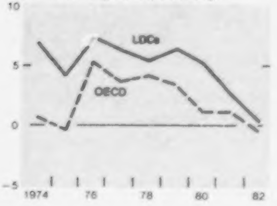
Furthermore, several critical ratios affecting countries' creditworthiness did not deteriorate. The major LDC borrowers' total external debt to banks and other lenders increased at about a 25% annual rate between the end of 1975 and the end of 1979 — from nearly $130 billion to approximately $310 billion. During this same period, their ex-

---

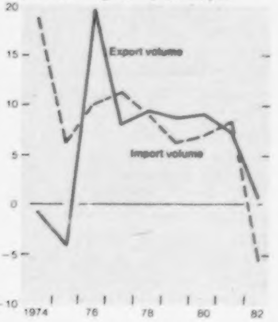
[*] Algeria, Argentina, Brazil, Chile, Colombia, Ecuador, Egypt, Indonesia, Israel, Ivory Coast, Korea, Malaysia, Mexico, Morocco, Nigeria, Peru, the Philippines, Taiwan, Thailand, Turkey, and Venezuela.

Growth and trade of 21 Major LDC borrowers and industrial countries

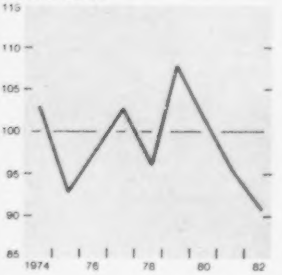
Real GNP growth
percent change from previous year



LDC merchandise trade volume
percent change from previous year



LDC terms of trade
ratio of export prices to import prices, 1976-79=100



ports of goods and services grew at a 22% annual rate, reflecting both favorable commodity price trends and strong growth of export volume. As a result, their total debt-to-exports ratio rose only slightly from 120% in 1975 to 133% at the end of the decade (see chart). Moreover all of the rise in this ratio reflected borrowings to build up foreign exchange reserves, which climbed from $33 billion at year-end 1975 to over $75 billion at year-end 1979. The ratio of total debt service (including short-term debt) to exports for the 21 major LDC borrowers increased from 37% in 1975 to 50% in 1979.

In sum, recycling after the first oil shock proceeded much more smoothly than even the optimists had expected. By financing the LDC current account deficits, banks, together with official institutions, played an enormously constructive role in preventing the 1974-75 recession from becoming more widespread and prolonged. Recovery in the industrial countries and declining real oil prices contributed to a subsequent narrowing of the LDC current account deficit and rapid export growth, such that there was little overall deterioration in LDC debt service ratios or creditworthiness. Of course, part of the reason developing countries did not experience much deterioration in their debt ratios is that world inflation, which continued to ratchet upward, eased their debt burdens. Moreover, generally permissive monetary policy in the United States and several other major industrial countries kept interest rates relatively low, often negative in real terms.

The same appraisal cannot be made of the experience after the second oil shock. A key difference is that the global economic environment has turned out to be far more difficult for borrowing countries in the 1980s than in the 1970s. Beginning in the United Kingdom in mid-1979 and subsequently in the United States in October 1979, governments and other economic policymakers in the major industrial countries increasingly became convinced that the upward ratcheting of inflation during successive business cycles had to be brought to an end. But given the difficulties of curbing government spending, the burden of fighting inflation was borne almost entirely by restrictive monetary policies, culminating in record-high nominal and real interest rates.

The commitment to fighting inflation by avoiding the creation of excess liquidity extended beyond national economic policies to those of international financial institutions. In contrast to initiatives after the first oil shock, no special IMF facilities were established or expanded after the second, and no new SDRs were created. Indeed, two years of delay preceded the 1980 ratification of a 50% increase in Fund quotas.

While some warnings were issued* that continued growth of banks' international lending was unsustainable, and that stepped-up official assistance was needed to help shoulder the burden of recycling, such views were clearly in the minority. Most monetary experts, from both public and private sectors, expressed confidence in the ability of the private banking system to continue playing the dominant role in recycling. Their faith reflected, in part, the relative ease with which the first shock had been handled. The rarity of defaults on sovereign loans and the fact that the banks' reported loan-loss experience was much better on interna-

---

*By spokesmen for the BIS and the Federal Reserve, for example, as well as by me in two papers: "The international monetary outlook for the 1980s: no time for complacency," delivered at a Board of Governors Meeting of the Atlantic Institute for International Affairs at Paris, France, December 8, 1979; and "International economic issues and priorities," submitted to the Congressional Economic Conference, Washington, D.C., December 10, 1980.

BEST AVAILABLE COPY

Table 2

Estimated gross external debt and debt service of 21 major LDC borrowers

	Gross external debt at end-1982 $ billions	Debt service in 1983, % of exports[1]	
		Total	Excluding rollover of short-term debt
Latin America			
Argentina	38.0	154	88
Brazil	85.5	117	67
Chile	17.2	104	54
Colombia	10.3	95	38
Ecuador	6.6	102	58
Mexico	80.1	126	59
Peru	11.5	79	47
Venezuela	29.5	101	25
Subtotal	278.1	117	56
Asia			
Indonesia	25.4	28	14
Korea	36.0	49	17
Malaysia	10.4	15	7
Philippines	16.6	79	33
Taiwan	9.3	19	6
Thailand	11.0	50	19
Subtotal	108.8	36	14
Middle East and Africa			
Algeria	16.3	35	30
Egypt	19.2	46	16
Israel	26.7	126	26
Ivory Coast	9.2	76	34
Morocco	10.3	65	36
Nigeria	9.3	28	14
Turkey	22.8	65	20
Subtotal	113.8	58	16
Total of 21 LDCs	501.2	71	30

[1] Interest on gross debt plus all maturing debt, including amortization of medium- and long-term debt and all short-term debt as percent of exports of goods and services, including net private transfer payments.

tional credits than on domestic loans contributed to a perception that sovereign lending risks were very small.

The attitude that "companies may fail, but countries do not" overlooked important distinctions between risks involved in lending to domestic firms and those in lending to foreign entities: first, although domestic loans often incorporate provisions that place restrictions on a firm's overall indebtedness, such covenants are seldom, if ever, included in sovereign loans, because they are difficult to enforce; and second, while it is true that countries do not go out of business, they are not always able or willing to pay their debts on a timely basis.

As a result of the relaxed attitudes that developed in the late 1970s, bank lending to developing countries continued to expand rapidly in the early 1980s, at over a 20% annual rate (see chart). Further, much of this lending continued to be concentrated heavily among certain borrowers — especially Mexico, Brazil, and Argentina. The nine largest U.S. banks' claims on these three countries rose at average annual rates of 35%, 15%, and 30%, respectively, between year-end 1979 and mid-1982. Much of the increase in bank claims on the major LDCs over this period was in the form of short-term credits. Such loans rose almost 30% per annum, reflecting the belief that they are less risky than longer-term credits. In reality, the rapid buildup of short-term debt increases borrowers' vulnerability to a sudden reduction in the willingness of lenders to roll over existing debt. Moreover, short-term lending provides little protection for banks as a group because they cannot all attempt to withdraw such credits at the same time without provoking a liquidity crisis for the borrower.

Accompanying the buildup of LDC debt was a marked deterioration in their debt servicing capacity, because of prolonged world recession and insufficient adjustment. World recession has slowed the growth of the major LDC borrowers' export volume from the 8%-9% average annual rate in the second half of the 1970s to only 1% last year. Falling dollar prices of internationally traded commodities have resulted in an 11% drop of export prices in dollar terms and an 11% decline in their terms of trade (export prices relative to import prices). The combination of slower export-volume growth and declining export prices left the dollar value of their exports in 1982 unchanged from that in 1980. Thus, even though the OPEC surplus has virtually disappeared (representing a current account swing of $110 billion in only two years), the combined current account deficit of the 21 major LDC borrowers has risen from an annual average of $30 billion in 1979-80 to nearly $65 billion in 1981-82, or from 12% of their exports of goods and services in 1979 to 23% in 1982.

The combination of a continued rapid debt buildup and stagnant exports pushed the major LDC borrowers' average outstanding debt in 1982 to over 170% of exports of goods and services — more than 40 percentage points above the average ratio of debt to exports for the second half of the 1970s. Meanwhile, high real interest rates and a shortening of debt maturities caused the total debt service ratio of the 21 countries to climb from 50% in 1979 to 75% during 1982 (see chart), with only modest decline projected for 1983 (see Table 2). As shown in Table 3, increases in debt service ratios were particularly large among the major Latin American borrowers. Their 1982 average was 125%, or about three times higher than that for the principal Asian borrowers. Under these circumstances, just a few confidence shattering develop-

Table 3

Selected external financial indicators for 21 major LDC borrowers

group averages

	21 LDCs			
	Total	*Latin America*[1]	*Asia*[2]	*Middle East*[3] *and Africa*
Total external debt[4] *as % of exports*[5]				
1979	133	196	73	130
1980	123	182	70	113
1981	140	202	78	138
1982	172	259	94	155
Total debt service[6] *as % of exports*[5]				
1979	50	76	27	46
1980	47	73	27	38
1981	60	92	33	49
1982	75	125	38	56
Current account deficit as % of exports[5]				
1979	12	21	7	8
1980	12	22	8	5
1981	22	31	12	24
1982	23	33	14	23

[1] Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, and Venezuela.

[2] Indonesia, Korea, Malaysia, Philippines, Taiwan, and Thailand.

[3] Algeria, Egypt, Israel, Ivory Coast, Morocco, Nigeria, and Turkey.

[4] Average of beginning- and end-year debt levels.

[5] Exports of goods and services.

[6] Interest on total external debt plus all maturing debt, including amortization of medium- and long-term debt and all short-term debt.

ments such as the Polish troubles, the Falklands conflict, and the Mexican foreign exchange crisis were sufficient to trigger the major slowdown in international lending that precipitated the current global debt situation.

With the benefit of hindsight, it is clear that the stage for this situation was set by two fundamental errors of judgment following the second oil shock. The first was overestimating the capacity of individual sovereign countries to handle their debt burden. Some traditional yardsticks applied in assessing creditworthiness were discarded by borrowers and lenders as long as they felt that countries had ready access to international capital markets. Lenders were drawn to an attractive and increasingly competitive market environment, as more and more banks became active participants in international loan syndications. Bank managements and governments — and the international institutions as well — were caught up in pervasive faith in almost inevitable economic growth. This was reflected in a multitude of forecasts that turned out to be overly optimistic, but had been used to justify the swelling debt outstandings.

That belief led to a second mistake: underestimating the extent of world recession, terms-of-trade deterioration, sustained high real interest rates, and the consequent impact on the ability of LDCs to service their debt. The impact can be gauged by comparing the actual development of LDC current account deficits and external debt with their hypothetical paths had no global recession ensued in 1980-82. Sustained moderate economic growth in industrial countries, unchanged LDC terms of trade, and positive, but not excessively high, real interest rates would have cut the actual current account deficits of the principal borrowing countries by half in 1961 and 1982. As shown in Table 4 and in the charts, their external indebtedness at year-end 1982 would have totaled $75 billion less than the actual $500 billion. And, with higher export earnings, the aggregate debt/export ratio for these countries would have been below the average ratio for the second half of the 1970s. Some individual borrowers that did not adjust adequately would still have witnessed a deterioration in their debt ratios, but it is unlikely that the current global debt situation would have emerged. However, under the conditions of an unexpectedly deep and prolonged world recession and exceptionally high real interest rates, even the better managed borrowing countries suffered a deterioration in their external financial positions. There was little that international banks could do to protect themselves against such an unforeseen eventuality.

Blueprint for reconstruction

Last October, our publication *World Financial Markets* put forward a "blueprint for reconstruction," which consisted of the following points:

- There must be significant economic adjustment in the developing countries to reduce their current account deficits.
- The banks must continue to be involved in both short- and medium-term lending.
- The IMF and other official lending institutions must be involved intensively in assisting and monitoring the international adjustment process.
- With inflation down, monetary and fiscal policies in industrial countries should be cautiously retuned to make moderate economic recovery a more certain prospect. I stress caution and moderation, which are necessary to avoid reviving inflationary excesses or fear of them.

Table 4

Hypothetical financing of 21 major LDC borrowers in the absence of OECD recession in 1980-82

annual rate percent changes from previous years, except as noted

	1980	1981	1982
External environment			
OECD real GNP growth			
— actual	1.3	1.3	—0.5
— no recession	3.0	3.0	3.0
LIBOR, % p.a.			
— actual	14.1	16.8	13.5
— no recession	9.5	9.5	9.5
Borrowing countries' terms of trade			
— actual	—2.0	—6.3	—4.6
— no recession	0.0	0.0	0.0
Borrowing countries' export volume			
— actual	9.3	7.5	1.1
— no recession	9.3	7.5	7.0
Borrowing countries			
Current account balance, $ billion			
— actual	—35	—64	—64
— no recession	—23	—29	—29
Current account, % of exports			
— actual	12	22	23
— no recession	9	10	9
Total debt, $ billion			
— actual	372	440	501
— no recession	342	384	420
Total debt, % of exports			
— actual	123	140	172
— no recession	124	127	124

The blueprint requires a judicious blend of adjustment and financing. It calls for a balanced approach, involving the active cooperation of the four principal parties: developing countries, international institutions, commercial banks, and industrial countries. Each will have distinct contributions to make. Excessive reliance on any one could jeopardize the rescue operation. If, for example, too much reliance is placed on austerity programs in the borrowing countries, internal political and social repercussions could undermine any progress achieved. Likewise, a lasting solution will require the industrial countries to lead a world economic recovery. Equally, even while recognizing that correction of imbalances will take several years and will require infusion of considerable new money by both commercial banks and official institutions, unduly accommodative financing would threaten restoration of financial market confidence.

To demonstrate the benefits of a balanced approach, we have developed three scenarios for the external finances of the 21 major borrowing countries under varying assumptions about the borrowers' ability to adjust and about the extent of industrial-country recovery. These assumptions and their implications are set out in Table 5 and the results presented in the charts.

Scenario A supposes that the borrowing countries make a major and sustained adjustment effort against the background of a moderate OECD recovery. The borrowing countries are assumed to hold the volume increase in their import needs this year to just 1%, rising to 7% in 1985 and beyond. Their real GNP growth is put at 1.5% this year, recovering to 5% in 1985 and a rate thereafter reasonably in line with their employment needs. Industrial countries are assumed to manage a 1.5% upturn in real GNP this year and moderate 3% gains in 1984 and 1985. Their demand for the export products of the borrowing countries would rise 3% by volume in 1983 and by 7% in both 1984 and 1985. The economic recovery permits the borrowing countries a slight gain — 1% — in their 1983 terms of trade and gains thereafter that cumulatively reverse two-thirds of their terms-of-trade losses since 1979. Interest rates hold near present levels, well below their 1982 average.

On these assumptions, the current account deficit of the 21 borrowing countries shrinks from the $64 billion deficits of 1981 and 1982 to $51 billion this year. The deficit would then drop further, reaching the 1979 level of $26 billion in 1985, before rising again gradually as import restraints are relaxed in the later years. More important, the ratio of their current account deficit to export earnings could return by 1985 to proportions not seen since before the first oil shock — and be sustained at around 6% for the remainder of the decade. Their outstanding debt would continue to grow in nominal terms, but in real terms it would decrease. Their debt/export ratio by the mid-1980s could revert to its 1977-79 average level. These developments would pave the way for the restoration of the borrowing countries' creditworthiness in private capital markets.

Scenario B retains the assumptions of the first scenario concerning the OECD recovery but posits less decisive borrowing-country adjustment. To permit slightly faster GNP growth, their import volume rebounds 3% this year, rather than being held to 1%, and in 1984-85 grows 1% faster than in Scenario A. Their export effort is somewhat less successful. The result is that their current account deficit is reduced from $64 billion to $57 billion in 1983, solely because of lower in-

Table 5

Financing scenarios for 21 major LDC borrowers

annual rate percent changes from previous year, except as noted; debt figures are for year-end

	Estimated	Scenario A Major LDC adjustment/ Moderate OECD recovery				Scenario B Partial LDC adjustment/ Moderate OECD recovery				Scenario C Major LDC adjustment/ Minimal OECD recovery			
	1982	1983	1984	1985	1986	1983	1984	1985	1986	1983	1984	1985	1986
External environment													
OECD real GNP growth	—0.5	1.5	3.0	3.0	2.5	1.5	3.0	3.0	2.5	0.5	1.5	2.0	2.0
OECD inflation (dollar terms)	0.0	9.5	10.0	7.0	7.0	9.5	10.0	7.0	7.0	7.5	8.5	8.0	7.0
LIBOR (six-month Eurodollar deposits, % per annum)	13.5	9.0	9.0	10.0	10.0	9.0	9.0	10.0	10.0	11.0	11.0	11.0	10.0
Borrowing countries' terms of trade	—4.6	1.0	3.0	4.0	0.0	1.0	3.0	4.0	0.0	—2.0	2.0	4.0	0.0
Borrowing countries' export volume growth[1]	1.1	3.0	7.0	7.0	6.0	3.0	6.0	6.0	6.0	1.5	3.0	4.0	4.0
Borrowing countries[2]													
Real GNP growth	0.3	1.5	3.0	5.0	5.0	2.0	3.5	5.5	5.0	1.5	3.0	5.0	5.0
Import volume growth[1]	—5.7	1.0	4.0	7.0	7.0	3.0	5.0	8.0	7.0	1.0	4.0	7.0	7.0
Current account balance, $ billion	—64	—51	—38	—27	—30	—57	—54	—55	—65	—73	—83	—91	—102
Current account balance, % of exports[1]	—23	—16	—10	—6	—6	—19	—14	—12	—13	—25	—25	—23	—24
Total debt, $ billion	501	553	595	627	662	558	616	675	744	567	655	751	857
Total debt, % of exports[1]	172	170	153	136	127	171	158	147	143	182	183	180	186
Debt to banks, $ billion[3]	311	333	356	381	408	333	356	381	408	333	356	381	408
IMF, official, and other debt,[4]													
$ billion	190	220	239	246	254	226	260	294	336	234	299	370	449
% change	9	16	9	3	4	19	15	13	15	23	28	24	21

[1] Goods and services.

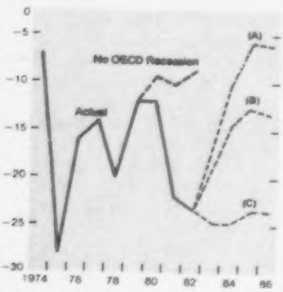
[2] Financing projections also incorporate assumptions on the relationship between LDC net interest payments and LIBOR; on private direct investment flows; and on reserve and other external asset use. No adjustments are made for valuation changes.

[3] All scenarios assume growth of bank debt at 7% per annum.

[4] Includes IMF, IBRD, Ex-Im Bank, and other official and suppliers' export credits.

Current account balance

as a percent of exports of goods and services



NOTE

(A) Major adjustment by borrowing countries, moderate OECD recovery

(B) Partial adjustment by borrowing countries, moderate OECD recovery

(C) Major adjustment by borrowing countries, minimal OECD recovery

The quantitative assumptions underlying Scenarios A, B & C are shown in Table 5

terest payments. The deficit shrinks little further thereafter. Indeed it climbs back to last year's level by 1986 and, in relation to export earnings, would not improve on the experience of the late 1970s. Such current account imbalances are much higher than desirable and mean that the borrowing countries' debt measured in real terms would not diminish, while their debt/export ratio would only return to its 1977-79 level toward the end of this decade. This would surely postpone and undermine the restoration of confidence in the ability of these countries to service their debts.

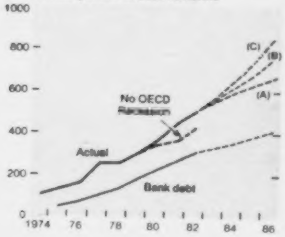
Scenario C offers the most disturbing prospect. While it assumes resolute adjustment on the part of the borrowing countries, as in Scenario A, it goes on to assume a minimal and delayed OECD recovery. The terms of trade facing borrowing countries would deteriorate again this year and in future years would recover less than in Scenario A. The export gains achievable by the borrowing countries would be severely limited. Despite rigorous adjustment efforts, the group's current account deficit would swell from last year's $64 billion to some $73 billion in 1983, and rise further in the years ahead. In relation to export earnings the current deficit would exhibit no material improvement and debt/export ratios would rise further. Financing needs would soar. Today's debt problems would only worsen.

Plainly, the thrust of international policy must be to ensure that actual

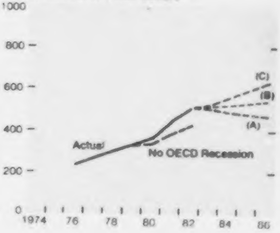
BEST AVAILABLE COPY

21 Major LDC borrowers

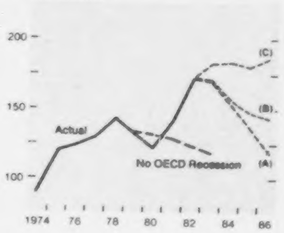
Total debt and debt to banks
in billions of dollars,
projections for 1983-87 assume 7% per annum growth in debt to banks



Total debt in real terms
in billions of 1982 dollars



Debt / export ratio
average of beginning and end-year total debt as a percent of exports of goods and services



NOTE
- (A) Major adjustment by borrowing countries moderate OECD recovery
- (B) Partial adjustment by borrowing countries, moderate OECD recovery
- (C) Major adjustment by borrowing countries minimal OECD recovery

The quantitative assumptions underlying Scenarios A, B & C are shown in Table 5.

developments parallel those envisioned in Scenario A. To date there are indications of progress on the borrower adjustment and the financing components of the blueprint. However, industrial-country recovery is less certain, although its potential contribution to solution of the debt problem dwarfs all others in significance, as can be seen in Scenario C.

Many of the major debtor countries are making strenuous efforts to bring their borrowing requirements in line with available financing. With their export markets still weak, these countries rely primarily on restrictive domestic policies and related cutbacks to reduce their current account deficits. For example, the austerity programs of Argentina, Brazil, and Mexico all aim at lowering public-sector deficits from about 15% of GNP in 1982 to about 5% in 1984. Drastic cuts in government spending and subsidies, as well as substantial revenue-raising measures, are already under way in these three countries. On the monetary front, credit expansion targets have been set far below those of 1982, and interest rate policies are becoming more realistic. Wage policies are being amended both to lessen their inflationary bias and to contain real wage gains. These tough policies are being pursued despite their obvious political and economic costs in terms of growth of output, investment plans, current living standards, and employment.

Many countries are also seeking to boost exports and curb imports through currency depreciation. In many instances, devaluations are warranted to correct earlier erosions of competitiveness, which often resulted from misguided reliance on an overvalued currency as an anti-inflationary tool or from failure to recognize the adverse consequences of targeting dollar exchange rates without considering the overvaluation of the dollar itself. For the time being, at least, depreciation may do little to expand exports of developing countries as a group because of the stagnant or shrinking markets offered by industrial countries. Patience will be needed because any attempts to secure quick export gains through excessive devaluation will be counterproductive, as they were in the 1930s, when competitive devaluations reinforced protectionism.

The benefits of austerity should be apparent this year in reduced imports and current account deficits. For the three largest debtors, the 1983 import bill will be barely $40 billion, compared with $55 billion in 1981. Their current account deficits will aggregate perhaps $13 billion, less than half the $30 billion imbalance in 1981.

On the financing front, a fruitful cooperation is emerging between the commercial banks and the IMF. The Fund's involvement and leverage over debtor countries has been crucial to getting commercial banks to agree to provide a substantial portion of the new financing needed to underwrite the adjustment programs of the main deficit countries. The Fund's role goes hand in hand with that of the banks: without IMF persuasion of the borrowing countries to undertake needed adjustment and in the absence of Fund monitoring of their progress, the banks would be unwilling to advance sufficient additional credit. The actual amount provided by the IMF is usually only a fraction of what a borrowing country needs, with the banks providing net additional credit that is a multiple of what the IMF lends.

As for the banks, they increasingly accept the necessity for continued lending to the major borrowing countries in support of their adjustment efforts. They acknowledge their responsibility, jointly with the

BEST AVAILABLE COPY

Table 6

External financing of 21 major LDC borrowers
billions of dollars

	1978	1979	1980	1981	1982	1983 Major LDC adjustment/Moderate OECD recovery[a]
Current account balance (deficit +)	21.3	26.4	34.6	64.2	64.0	51
Change in external assets (mainly reserves)	17.5	19.9	19.1	—0.6	—15.6	4.5
Private direct investment, net (inflows —)	—4.9	—6.5	—6.7	—8.3	—6.4	—7
Other[b]	—4.1	11.5	15.5	21.7	10.6	3.5
Change in total debt	57.8	51.3	62.5	77.0	52.6	52
Commercial banks	37.8	43.2	44.8	46.9	37.6	22
IMF	—0.1	—0.3	0.8	1.8	1.5	8.5
Official creditors, suppliers, and other	20.1	8.4	16.9	28.3	13.5	21.5
Total debt outstanding, year-end	256	309	372	449	501	553
Owed to commercial banks	139	182	227	274	311	333
% change	37.5	31.1	24.6	20.7	13.5	7
Owed to IMF, official and other creditors	119	127	145	175	190	220
% change	20.2	6.7	14.2	20.7	8.5	16

[a] Under assumptions of Scenario A, Table 5.
[b] Errors and omissions, plus net valuation adjustments. A positive figure adds to the change in total debt.

IMF, to encourage the borrowing countries' return to creditworthiness and to speed the resumption of a mutually beneficial relationship between lenders and borrowers. Evidence of the banks' constructive stance lies in the relative success with which they are assembling the new financing for 1983 that represents their contribution to the IMF-sponsored adjustment programs of Brazil and Mexico.

The financing scenarios for the 21 major LDC borrowers as a group envisage a 7% growth in net bank lending, both in 1983 and in later years — approximately the rate incorporated in the Brazil and Mexico programs for this year. Other sources of finance include the IMF, other official lenders such as the World Bank and its sister development institutions, export financing agencies, and nonbank trade creditors.

In Scenario A, total debt of the major borrowers rises from approximately $500 billion at year-end 1982 to $625 billion by the end of 1985. Of this $125 billion increase, the banks would extend $70 billion, or 56%, based on 7% per annum growth in their exposure. Official and other nonbank sources would furnish the residual $55 billion over the three-year period, their net lending proceeding at a slower average pace than in the past three years (see Table 6). The composition of this lending would shift, however. Export finance would play a less prominent role, in line with the curtailed growth of LDC imports. Official sources would be required to fill the gap. Starting with projected net IMF lending of $8.5 billion to the 21 major countries in 1983, compared with $1.5 billion in 1982, the Fund, World Bank, and other international organizations should jointly be able to extend net credit of $30 billion over the three-year period to 1985. This expectation presumes, of course, that the proposed expansion of IMF resources goes through. The residual $25 billion financing need from other nonbank sources should reasonably be attainable through bilateral official channels and private suppliers' credits.

Under Scenario B, with slippage in LDC adjustment, 7% growth in commercial bank lending leads to a $100 billion requirement from official and other nonbank sources over three years. Present thinking does not envisage growth of IMF and multilateral lending much beyond the $30 billion provision contemplated under Scenario A. The remaining $70 billion would have to come from bilateral official and private sources. But the consequent increases in exposure to several of the major borrowers look thoroughly implausible. Still worse, should OECD recovery fail, as in Scenario C, the hypothetical financing burden on nonbank sources balloons to $180 billion through 1985. Plainly, Scenarios B and C cannot realistically be financed. If their economic assumptions came to pass there would arise unmanageable pressures for yet harsher LDC adjustment and retrenchment. This would prevent world economic recovery, would pose grave risk of widespread financial defaults, and would threaten social and political stability. Success in guiding developments toward the path of Scenario A is therefore critical, especially the key ingredient of industrial-country recovery.

Yet the outlook for OECD economic recovery looms as the greatest uncertainty, both in the near term and for the balance of the 1980s. It is encouraging that nominal interest rates now are down substantially from both the peaks and the average of 1982. This reduces the net interest payments burden on the 21 major LDC borrowers by some $7 billion this year, about half the expected improvement in their current account deficit according to Scenario A. Yet real interest rates remain high to borrowers in both developing nations and the industrial countries themselves.

Official policy in the major industrial countries continues to place high priority on reducing inflation. Given the striking success achieved to that end over the past year, the time has come to recast the balance and thrust of macroeconomic policies in a cautiously expansive direction. Passively awaiting spontaneous recovery of the global economy is both risky and wasteful. Last month a panel of 26 economists, including myself, under the auspices of the Institute for International Economics here in Washington, pointed to the desirability of an easing of monetary policies in the United States, Canada, and Britain. Relaxation of fiscal policies was urged on Japan, Britain, and Germany. These recommendations have much merit, not only to provide a healthier and more certain economic environment in which to work out the problems of debtor nations but also to arrest the worrying slide in employment in the industrial countries.

Successful resolution of the global debt problem will bring benefits not just to lenders and debtors, but to all. The industrial countries should realize that their own return to prosperity would be hamstrung by failure to resolve the financial difficulties of LDCs. In 1981, developing countries absorbed 26% of the merchandise exports of industrial countries as a group, accounting for 4% of OECD GNP. Inability to sustain those exports would be a major drag on OECD recovery.

For the United States, even more than for other industrial nations, developing countries represent a major market for exports of farm products and manufactured goods, as well as of numerous services. U.S. merchandise shipments to developing countries totaled $90 billion in 1981, 38% of all U.S. exports. The fraction destined for Latin America alone was nearly 17%. Financial arrangements that enable developing countries to maintain and eventually expand their purchases from the United States will benefit our domestic output and employment. It should not be overlooked that one in six American workers employed in manufacturing and services is engaged in the export sector. Exports of $10 billion can provide jobs in the United States for over 200,000 workers.

Conclusions and recommendations

Several conclusions grow out of this analysis.

First, the debt problems of the developing countries appear manageable — in terms of the impact on the international financial system — provided there is a proper blend of adjustment and financing among LDCs, industrial countries, banks, and official institutions. The blueprint sketched out is not easy, but it is feasible. Renewed expansion of LDC export markets and gradually improving LDC terms of trade depend crucially on sustained, albeit moderate, economic recovery in industrial countries. Such recovery requires a cautiously expansive redirection of policies in industrial countries that diminishes real interest rates and holds inflationary expectations in check.

Second, it will still take considerable time — perhaps three to four years of sustained effort — for major LDC borrowers to restore their creditworthiness, regain normal access to financial markets, and resume robust economic growth. It may take less time for several major borrowers to reduce their debt levels and debt servicing requirements, relative to exports, to the positions that prevailed in the mid-1970s.

Third, while dealing with the international debt situation requires a sharing of burdens, it will also mean sharing the benefits. To be sure, debtor countries and banks stand to gain, but so too do the industrial nations. The LDCs are major markets for exports from all industrial countries and especially those from the United States. Our own return to prosperity depends in part on resolving the global debt problem.

Fourth, even after current debt problems are resolved, the foregoing analysis suggests countries should not count on the same rapid pace of bank lending as in the recent past. Fewer banks are likely to participate in new LDC lending in the future. Those that continue will do so at a slower pace after their recent credit experience.

Fifth, raising IMF quotas by 50% and enlarging the General Arrangements to Borrow (GAB) facility, while making it available to nonindustrial countries are absolute necessities. As of year-end 1982, the Fund's holdings of usable currencies and SDRs are estimated to have been about $20 billion, with undrawn credit lines with various countries (excluding those under the GAB) adding close to $10 billion. Against this, the IMF already has committed, or is about to commit, almost $25 billion through programs with Mexico, Brazil, Argentina, and other countries. Hence, the Fund's uncommitted lending pool is being depleted rapidly.

A 50% increase in IMF quotas would eventually yield more than $15 billion in new usable currencies, and another $15-$20 billion would be provided by the proposed enlargement and revision of the GAB. Saudi Arabia reportedly indicated that it would lend over $2 billion to the GAB. In addition, it would provide the IMF with over $4 billion, the final installment under a 1981 agreement, under which more than $8 billion already has been contributed. By adding approximately $35-$40 billion to available resources, these funding actions would restore the Fund's liquidity and enable it to maintain its lending momentum for several years, as is required even under such favorable assumptions as those of Scenario A, described earlier. Sustained IMF lending is crucial to smooth the transition until major LDC borrowers regain access to markets.

Sixth, the World Bank, the IMF's half-forgotten twin, needs to play a bigger role. In recent years, it has focused increasingly on the poorest countries — those that require concessional assistance through IDA — while seeking to "graduate" those higher-income countries with access to the international capital markets. This policy reflected great optimism about the export prospects of developing countries — optimism based on projections of high economic growth in the OECD countries, low interest rates, and improving terms of trade for the LDCs. Unfortunately, the actual experience has been painfully different, and many of the World Bank's LDC clients now find themselves burdened with high-cost, short-term obligations to commercial banks. As a result of recent events, it may be years before some LDCs have access to the international bond markets. Ensuring that they get the long-term funds needed for economic development may require the IBRD to rethink its lending priorities. It will also require governments to speed up the planned $40 billion increase in the bank's capital. In the meantime, the World Bank should accelerate its project and structural-adjustment lending to support, in a major way, those LDCs that show a willingness to take actions that promote exports. And it should revise self-imposed procedures that slow the commitment and disbursement of funds.

Seventh, we clearly must strengthen the international financial system to make it better able to deal with emergency situations and to reduce the likelihood of their recurrence. Institutional arrangements for handling emergency problems during the interval between their emergence and the conclusion of negotiations for IMF-supervised adjustment programs need to be improved. So far, crisis situations, such as those involving Mexico, Brazil, and Hungary, have been handled successfully on an ad hoc basis because bridge financing from central banks, coordinated through the BIS, was forthcoming along with assistance directly from the U.S. government and the banks. Procedures for supplying emergency funds are now complex, involving varied institutional arrangements among major countries for obtaining governmental or central bank approvals.

The role of the BIS could be strengthened by broadening its own capacity to furnish short-term liquidity. At the same time, the past hesitancy of the United States to become a member of the BIS should be reconsidered. Credit lines with the central banks of the G-10 countries could be established that would make it possible for the BIS to provide short-term assistance to the main borrowing countries. Such financing, of course, would have to be contingent on progress toward agreement with the IMF, so as to complement, rather than substitute for, Fund assistance and conditionality. This would be well within the original intent of the BIS, which was established in part to deal with international debt problems.

The international financial system also needs better information and analysis to assist borrowers and lenders in avoiding surges or excessive concentrations of international credit. Both the Fund and the BIS are well suited to help formulate improved yardsticks about debt service capabilities and other criteria of country creditworthiness. The IMF has expertise and information on countries' future borrowing requirements and behavior; the BIS and the central banks of the industrial countries have detailed information on bank lending and the maturity profile of outstanding bank credits. By exchanging information, a more complete picture could be formed of the external financial conditions of the debtor countries. The central banks could then use such information in their dealings with commercial banks in their jurisdiction. The IMF, in turn, could better guide the deficit countries in avoiding rapid debt buildup, especially short-term debt concentrations.

In this connection, a positive development is under way in the private sector through the establishing of an institute intended to improve the quality of timely country financial data available to the international banking community.

In concluding my remarks, it may be helpful to recall that we have been through similar problems in the past. In early 1974, for example, many feared that the quadrupling of the world price of oil had created a balance of payments problem so severe that it was certain to bring on global financial collapse. Yet we overcame that problem — with calm reason and international cooperation. We can do it again. We have already moved back from the precipice. Although there are no guarantees, a solution to the world debt problem is within reach. Bank lending must continue to support LDC adjustment efforts. Industrial countries must develop policies that will sustain economic recovery. The IMF and the World Bank must receive strong support. These two institutions were created at the end of World War II specifically to prevent a recurrence of the kind of inward-looking policies that plunged the world into depression in the 1930s. Today, at a time when there are dangerous parallels to conditions of 50 years ago, the IMF and the World Bank have never been more needed. We must not pull back from our international responsibilities, nor should we seem to encourage other countries to pull back from theirs. It is in the self-interest of all parties that each does its part.

Statistical appendix

for key to data in tables see November 1982 issue.

Effective exchange rates, 16

Real effective exchange rates, 16

Eurocurrency market size, 17

Eurocurrency deposit rates, 17

Eurocurrency bank credits, 18

International bond yields, 18

New international bond issues, 19

Central bank discount rates, 20

Day-to-day money rates, 20

Treasury bill rates, 21

Representative money-market rates, 21

Commercial bank deposit rates, 22

Commercial bank lending rates to prime borrowers, 22

Domestic government bond yields, 23

Domestic corporate bond yields, 23

Information herein is from sources considered to be reliable but is furnished without responsibility on the part of Morgan Guaranty Trust Company.

Effective exchange rates

Index numbers. March 1973 = 100. The index of the effective exchange rate for a currency is a measure of that currency's trade-weighted average appreciation or depreciation vis-à-vis the currencies of 15 other major countries. The exchange rates used in the construction of this index are the averages of daily noon spot exchange rates in New York for months and for weeks ending on dates shown. The trade weights used are based on 1976 bilateral trade in manufactures.

	United States	Canada	Japan	United Kingdom	Germany	France	Italy	Belgium	Netherlands	Switzerland	Austria	Denmark	Norway	Sweden	Australia	Spain
pre-June 1970 parities	118.5	94.9	79.3	116.2	91.6	97.5	110.9	95.9	98.2	88.3	97.8	97.9	98.1	102.2	92.2	98.4
Smithsonian central rates	107.0	101.3	88.7	116.0	95.4	96.1	108.3	97.0	99.1	91.6	98.0	96.0	96.3	100.5	91.7	98.1
1982																
January	109.2	84.6	121.5	78.0	137.0	81.9	45.9	104.6	118.7	186.2	122.2	85.6	107.8	81.4	80.8	63.2
February	112.3	83.5	117.6	78.5	136.8	81.8	45.9	102.0	118.8	186.8	121.9	84.5	108.6	81.6	80.7	63.3
March	114.1	83.3	115.6	78.0	139.1	81.9	45.6	95.8	120.6	190.0	122.4	83.1	109.6	81.9	80.1	61.9
April	115.2	83.2	115.0	77.5	140.4	81.6	45.2	95.1	120.3	185.0	123.1	82.9	110.0	81.8	80.3	61.8
May	113.6	82.3	117.2	77.4	141.6	82.3	45.2	95.7	120.7	180.9	123.8	84.1	109.2	81.4	79.3	62.1
June	118.8	80.2	112.9	78.5	142.0	78.9	45.0	95.4	121.6	178.1	123.8	82.5	110.1	81.9	80.2	61.4
July	119.9	80.7	112.1	78.8	142.6	76.8	45.1	95.6	122.0	179.7	124.1	82.0	108.8	82.0	79.3	61.1
August	119.8	82.5	110.9	78.9	142.8	76.5	45.0	95.3	122.8	179.6	124.3	81.7	104.2	82.7	77.3	61.2
September	120.4	83.3	109.7	79.2	143.2	75.8	45.0	94.8	123.6	179.1	124.6	81.3	102.0	82.6	76.4	61.4
October	121.9	83.9	107.2	80.0	144.4	76.0	44.7	94.5	124.9	179.5	124.2	83.5	102.2	73.0	76.5	61.1
November	121.9	84.3	110.9	77.6	144.8	76.3	44.2	94.6	125.3	180.0	125.9	84.7	103.1	70.3	76.6	59.6
December	118.7	83.0	119.5	74.1	147.3	77.5	44.7	94.9	125.7	184.5	127.1	86.2	102.7	69.3	76.0	54.2
3	119.7	83.1	116.7	75.5	146.6	77.2	44.3	94.2	125.4	182.4	126.3	85.3	103.9	69.6	76.0	58.6
10	119.1	82.9	118.8	74.6	146.9	77.3	44.6	94.9	125.8	184.4	127.0	86.1	103.8	69.6	76.0	53.8
17	119.2	83.1	118.6	74.4	147.2	77.4	44.6	94.8	125.8	184.4	126.8	85.9	103.1	69.5	76.0	53.5
24	118.3	83.0	120.0	73.1	147.6	77.6	44.8	95.3	125.7	187.6	126.8	86.5	102.3	69.3	76.0	53.6
31	117.2	82.9	122.5	73.1	147.7	77.8	45.0	95.2	125.8	187.3	127.2	86.7	101.4	69.1	75.8	53.7
1983																
January 7	116.1	83.3	124.7	72.5	148.1	77.8	45.0	95.0	126.0	189.1	127.2	86.7	101.4	69.0	75.8	53.5
14	115.9	83.8	124.9	70.6	148.0	77.9	45.3	95.2	126.6	192.6	127.4	87.2	101.5	69.1	76.2	53.4
21	117.2	83.8	123.4	71.5	146.9	77.4	45.1	95.4	126.5	192.3	127.1	86.6	102.3	69.3	76.5	53.4

Real effective exchange rates

Index numbers, March 1973 = 100. The index of the real effective exchange rate is the index of the effective exchange rate adjusted for inflation differentials which are measured by wholesale prices of nonfood manufactures. Exchange rates and trade weights used in the construction of this index are the same as those used for effective exchange rate indices. Annual figures are averages of months.

	United States	Canada	Japan	United Kingdom	Germany	France	Italy	Belgium	Netherlands	Switzerland	Austria	Denmark	Norway	Sweden	Australia	Spain
1979	96.3	92.1	95.7	118.4	103.9	98.9	93.0	95.8	100.5	116.8	107.6	100.7	92.6	99.0	88.2	109.0
1980	98.0	91.3	93.4	137.9	100.8	100.6	95.9	90.6	97.1	106.5	108.2	93.3	94.8	100.5	89.7	103.1
1981	108.7	91.4	94.3	140.9	96.6	98.9	91.2	85.0	93.1	105.5	106.1	89.1	99.2	101.3	98.9	97.6
1982	117.4	91.8	83.5	135.2	99.7	96.3	89.9	77.5	97.1	109.1	107.0	86.9	100.3	94.8	101.3	98.4
1982																
January	110.8	92.8	90.5	135.8	98.0	97.3	89.7	82.7	95.9	112.4	106.4	87.6	102.2	96.7	99.7	98.5
February	113.1	92.1	87.4	136.7	97.1	98.5	90.5	80.5	95.7	112.2	106.0	86.6	103.5	97.6	101.0	99.0
March	114.4	92.4	85.7	135.6	98.1	98.4	90.0	77.4	96.7	114.0	107.3	85.9	102.9	98.2	101.3	97.8
April	114.8	93.0	85.1	134.7	98.6	98.9	89.5	77.1	96.2	111.0	107.6	86.2	103.8	98.1	102.0	98.3
May	112.7	92.1	86.4	134.3	99.1	100.6	89.6	77.9	96.3	108.5	107.8	86.8	103.5	97.7	101.3	99.7
June	118.5	89.4	82.5	136.2	99.7	96.3	88.9	77.7	96.9	107.1	107.3	86.3	103.2	97.7	102.8	99.3
July	120.3	89.4	81.3	136.9	99.9	94.3	89.2	77.5	96.9	107.3	107.5	85.8	101.8	98.3	102.4	99.2
August	120.4	90.9	80.4	137.1	100.0	93.3	89.7	77.5	97.2	107.3	107.4	86.1	97.7	99.1	100.5	99.8
September	119.8	92.9	79.7	138.1	100.4	92.5	90.0	76.9	97.5	107.2	107.1	85.8	96.4	99.0	100.1	99.8
October	122.7	92.3	77.2	139.5	100.9	92.7	89.7	76.6	98.0	107.4	107.5	88.7	96.8	88.7	100.1	99.6
November	122.7	92.6	79.7	135.4	100.7	93.6	89.7	76.4	98.1	107.6	107.4	90.1	97.8	86.6	101.1	97.5
December	119.1	91.2	85.7	130.1	102.6	95.4	90.7	76.5	98.0	109.4	108.2	92.1	97.3	85.1	101.0	98.8

Eurocurrency market size

based on foreign-currency liabilities and claims of banks in major European countries, the Bahamas, Bahrain, Cayman Islands, Netherlands Antilles, Panama, Canada, Japan, Hong Kong, and Singapore
billions of dollars (rounded to nearest $5 billion), at end of period

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	
										Jun[r]	Sep
Estimated size											
Gross	315	395	485	595	740	950	1 235	1 525	1 860	1 915	2 015
Liabilities to nonbanks	55	80	90	115	145	190	260	345	440	465	475
Liabilities to central banks	40	60	65	80	100	115	145	150	130	110	105
Liabilities to other banks[a]	220	255	330	400	495	645	830	1 030	1 290	1 340	1 435
Net	160	220	255	320	390	495	590	730	890	910	940
Claims on nonbanks	70	105	130	165	210	265	330	425	530	550	575
Claims on central banks and on banks outside market area[b]	70	95	105	130	150	185	200	230	275	270	275
Conversions of Eurofunds into domestic currencies by banks in market area[c]	20	20	20	25	30	45	60	75	85	90	90
Eurodollars as % of gross liabilities in all Eurocurrencies	74	76	78	80	76	74	72	75	78	80	81

a includes unallocated liabilities
b includes unallocated claims
c in European market area only
r revised
p preliminary

Eurocurrency deposit rates

prime banks' bid rates in London, at or near end of month

	1979	1980	1981	1982							
	Dec	Dec	Dec	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Eurodollar:											
overnight	14.00	19.25	12.87	13.62	14.88	11.50	9.00	10.50	9.50	8.88	9.25
7-day fixed	14.00	19.75	13.00	14.00	15.38	11.75	9.25	10.50	9.50	9.00	9.25
one month	14.37	19.12	13.31	14.38	15.44	12.13	10.94	11.00	9.62	9.38	9.12
three months	14.44	17.55	13.75	14.38	15.81	13.06	11.88	11.44	10.00	9.88	9.19
six months	14.44	16.37	14.81	14.44	16.00	13.38	12.44	11.94	10.19	10.13	9.50
twelve months	12.87	14.87	14.75	14.44	16.00	14.06	12.87	12.19	10.50	10.38	9.62
Euromark:											
one month	8.50	8.87	10.44	8.56	8.87	8.87	8.12	7.62	7.00	7.19	5.87
three months	8.56	8.87	10.50	8.56	9.00	8.87	8.19	7.75	7.00	7.06	5.87
six months	8.56	8.87	10.56	8.56	9.12	9.12	8.44	7.94	7.00	7.06	5.94
twelve months	8.12	8.93	10.25	8.50	9.25	9.12	8.44	7.94	6.94	7.00	6.00
Euro-Swiss franc:											
one month	5.19	6.00	8.87	3.63	4.37	3.25	3.25	3.81	3.00	3.94	2.81
three months	5.75	6.00	9.25	4.25	5.06	4.25	4.00	4.37	3.56	4.06	3.25
six months	5.87	5.75	9.25	4.94	5.94	5.12	4.88	4.81	4.12	4.06	3.44
twelve months	5.56	5.50	8.50	5.06	6.00	5.12	4.94	4.81	4.19	4.19	3.44
Eurosterling:											
one month	16.75	14.75	15.37	13.37	13.00	11.88	11.00	10.88	9.87	10.44	10.56
three months	16.75	14.75	15.69	13.37	13.06	11.81	10.81	10.50	9.44	10.44	10.44
six months	16.75	14.25	15.69	13.37	13.06	11.81	10.81	10.50	9.44	10.38	10.31
twelve months	15.25	14.00	15.37	13.37	13.13	11.94	10.81	10.50	9.44	10.31	10.31
Euro-French franc:											
one month	13.87	11.12	15.75	29.50	15.50	14.75	21.00	16.25	20.00	19.50	23.00
three months	14.00	11.75	17.00	26.75	16.75	16.00	23.75	18.00	20.00	19.75	24.00
six months	14.12	12.25	18.00	23.75	18.00	17.37	22.75	19.00	20.00	20.38	22.00
twelve months	13.75	12.87	18.25	23.75	18.63	18.00	21.00	19.25	19.00	20.00	19.75
Euroyen:											
one month	7.32	9.12	6.12	7.06	7.25	6.88	7.06	7.00	6.75	7.31	6.75
three months	8.31	9.25	6.12	7.12	7.25	7.12	7.31	7.25	6.87	7.25	6.75
six months	8.62	9.62	6.87	7.12	7.31	7.38	7.44	7.50	6.94	7.19	6.81
twelve months	7.94	9.37	6.87	7.38	7.25	7.12	7.44	7.56	7.00	7.19	6.81

Eurocurrency bank credits

publicly announced in period, in millions of dollars

	1980	1981	1982	1982		1983	Jan	
				Nov[r]	Dec[r]	Jan[p]	1983	1982
Industrial countries	**39 100**	**86 022**	**42 507**	**1 615**	**1 662**	**1 562**	**1 562**	**4 923**
Australia	2 475	1 680	4 721	150	275	—	—	1 502
Canada	1 743	4 112	3 838	—	60	—	—	1 750
Denmark	1 720	1 661	789	—	19	1 000	1 000	85
France	1 745	3 912	5 653	70	63	—	—	—
Greece	1 333	1 039	770	20	—	20	20	—
Ireland	237	1 361	401	—	—	—	—	—
Italy	6 268	6 030	3 457	302	153	92	92	177
Norway	685	713	2 069	—	100	—	—	27
Portugal	745	1 590	1 388	80	150	—	—	51
Spain	5 457	3 242	1 806	220	194	—	—	155
Sweden	1 370	1 867	649	174	50	—	—	—
United Kingdom	1 470	747	1 635	80	—	—	—	37
United States	6 719	54 784	6 566	230	470	450	450	779
Others[a]	7 133	3 284	8 765	289	128	—	—	360
Developing countries	**35 054**	**45 239**	**40 756**	**2 412**	**2 382**	**5 564**	**5 564**	**2 296**
Non-OPEC countries	24 009	33 369	28 251	1 592	2 122	5 327	5 327	1 685
Argentina	2 506	2 534	1 565	—	1 100	—	—	80
Brazil	4 158	5 751	5 716	485	316	—	—	705
Chile	1 322	2 204	1 194	—	—	—	—	14
Colombia	608	1 005	227	—	70	—	—	—
Korea	1 917	2 824	2 923	340	123	100	100	57
Malaysia	—	1 725	1 909	15	72	40	40	—
Mexico	5 971	7 530	7 953	450	15	5 000	5 000	435
Peru	408	1 407	1 069	—	—	—	—	—
Philippines	1 056	1 257	635	52	55	—	—	—
Taiwan	314	928	255	—	—	—	—	—
Other	5 677	6 204	4 805	250	371	187	187	394
OPEC countries	11 045	11 870	12 505	820	260	237	237	611
Ecuador	1 209	934	815	—	—	—	—	20
Indonesia	1 435	725	1 035	29	59	—	—	—
Nigeria	1 330	1 802	2 042	27	52	—	—	—
United Arab Emirates	101	363	93	—	—	—	—	—
Venezuela	6 715	7 559	6 799	164	20	237	237	496
Other	255	497	1 721	600	129	—	—	95
Communist countries	**2 809**	**1 791**	**765**	**10**	**83**	—	—	**80**
China	181	370	43	10	33	—	—	—
East Germany	303	470	8	—	—	—	—	—
Hungary	550	550	340	—	50	—	—	—
Poland	800	—	—	—	—	—	—	—
Other[b]	975	401	374	—	—	—	—	80
International organizations[c]	**429**	**302**	**150**	—	—	—	—	**150**
TOTAL	**77 392**	**133 354**	**84 178**	**4 037**	**4 127**	**7 126**	**7 126**	**7 449**

a includes multinational organizations b includes COMECON institutions c includes regional development organizations p preliminary
r revised

International bond yields

long-term issues, at or near end of month

	1979	1980	1981	1982							
	Dec	Dec	Dec	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
U.S. companies:											
U.S. dollar	10.13	11.76	12.70	13.02	13.41	13.33	13.04	12.92	11.63	11.32	11.28
Swiss franc	6.61	7.27	7.30	7.40	7.66	7.53	7.64	7.92	7.87	7.87	7.75
European companies:											
U.S. dollar	10.93	12.42	14.29	13.83	14.12	14.15	13.81	13.73	12.81	12.37	12.45
German mark	7.55	8.79	9.36	8.23	8.35	8.28	8.32	8.24	8.23	8.31	8.17
Governments:											
U.S. dollar	10.66	11.83	13.59	13.50	13.77	13.78	13.41	13.30	12.62	12.00	12.51

New international bond issues*

new issues in period, in millions of dollars

	1980	1981	1982	1982		1983	Jan	
				Novr	Decr	Janp	1983	1982
By type:								
Eurobonds, total	**23 970**	**31 616**	**49 839**	**3 773**	**1 838**	**4 521**	**4 521**	**4 007**
by category of borrower								
U.S. companies	4 107	6 178	12 596	435	41	387	387	1 493
Foreign companies	9 032	12 882	13 231	1 386	597	685	685	1 597
State enterprises	5 839	7 496	13 529	656	488	1 487	1 487	883
Governments	3 045	2 629	7 107	1 047	512	1 662	1 662	34
International organizations	1 947	2 431	3 376	249	200	300	300	—
by currency of denomination								
U.S. dollar	16 427	26 830	42 930	2 472	1 697	4 040	4 040	3 667
German mark	3 607	1 277	2 487	403	103	253	253	22
Dutch guilder	1 043	529	645	36	—	—	—	—
Canadian dollar	279	634	1 181	33	—	20	20	248
European composite units	65	309	1 301	739	38	208	208	45
Other	2 549	2 037	1 295	90	—	—	—	25
Foreign bonds outside the United States, total	**14 521**	**13 817**	**19 879**	**1 318**	**689**	**1 647**	**1 647**	**2 221**
by category of borrower								
U.S. companies	307	592	1 071	—	98	103	103	108
Foreign companies	3 157	3 384	4 184	384	171	563	563	506
State enterprises	2 830	3 701	5 429	429	190	240	240	668
Governments	4 086	2 762	3 494	175	49	251	251	239
International organizations	4 141	3 378	4 801	330	181	490	490	698
by currency of denomination								
German mark	4 839	1 310	2 745	255	—	411	411	418
Swiss franc	7 617	8 285	11 129	678	367	993	993	1 394
Dutch guilder	259	481	957	72	38	—	—	139
Japanese yen	1 088	2 457	3 418	239	187	218	218	246
Other	718	1 284	1 630	74	97	25	25	24
Foreign bonds in the United States, total	**3 429**	**7 552**	**6 096**	**149**	—	**39**	**39**	**228**
by category of borrower								
Canadian entities	2 138	4 630	3 330	49	—	9	9	200
International organizations	550	1 375	1 700	—	—	—	—	—
Other	743	1 547	1 066	100	—	30	30	28
By country of borrower:								
Industrial countries	**32 732**	**40 978**	**61 142**	**4 230**	**2 006**	**5 387**	**5 387**	**5 229**
Australia	539	991	2 167	91	21	207	207	45
Austria	1 859	1 557	1 668	39	—	42	42	118
Canada	3 797	10 648	11 909	387	49	329	329	823
Denmark	1 125	695	1 019	57	—	313	313	13
Finland	392	672	815	76	—	105	105	44
France	2 820	3 156	7 393	353	308	1 146	1 146	531
Italy	904	1 106	1 746	729	—	99	99	284
Japan	5 309	6 928	8 213	1 017	466	701	701	1 194
Netherlands	1 585	630	865	36	—	56	56	—
New Zealand	293	1 107	1 375	92	300	—	—	—
Norway	892	530	832	—	—	—	—	22
Sweden	3 244	2 050	2 729	105	462	1 298	1 298	226
United Kingdom	1 733	1 406	1 281	396	100	40	40	—
United States	5 587	6 770	14 567	435	139	490	490	1 601
Developing countries	**2 485**	**4 769**	**4 930**	**431**	**140**	**50**	**50**	**484**
Non-OPEC countries	1 942	4 338	3 890	431	90	50	50	484
Brazil	349	60	91	—	—	—	—	—
Korea	68	323	172	10	20	50	50	20
Mexico	544	3 012	1 919	—	—	—	—	377
OPEC countries	543	431	1 040	—	50	—	—	—
Venezuela	398	291	385	—	—	—	—	—
Communist countries	**65**	**75**	**65**	—	—	—	—	**45**
International organizations	**6 638**	**7 183**	**9 677**	**579**	**381**	**790**	**790**	**698**
TOTAL	**41 920**	**52 985**	**75 814**	**5 240**	**2 527**	**6 207**	**6 207**	**6 456**

*Beginning November 1982, deferred payment issues are recorded in month(s) payments are actually made.

Central bank discount rates

	1979	1980	1981	1982				Current	
	end Dec	end Dec	end Dec	end Mar	end Jun	end Sep	end Dec	Jan 24 1983	effective since
United States	12.00	13.00	12.00	12.00	12.00	10.00	8.50	8.50	Dec 14, 82
Canada	14.00	17.36	14.66	15.11	16.58	12.98	10.26	9.81	Jan 20, 83
Japan	6.25	7.25	5.50	5.50	5.50	5.50	5.50	5.50	Dec 11, 81
United Kingdom	17.00	14.00	14.37	13.00	12.50	10.00	10.00	11.00	Jan 12, 83
Belgium	10.50	12.00	15.00	13.00	14.00	12.50	11.50	11.50	Nov 12, 82
France	9.50	9.50	9.50	9.50	9.50	9.50	9.50	9.50	Aug 31, 77
Germany	6.00	7.50	7.50	7.50	7.50	7.00	5.00	5.00	Dec 3, 82
Italy	15.00	16.50	19.00	19.00	19.00	18.00	18.00	18.00	Aug 24, 82
Netherlands	9.50	8.00	9.00	8.00	8.00	7.00	5.00	4.50	Jan 14, 83
Austria	3.75	6.75	6.75	6.75	6.75	6.25	4.75	4.75	Dec 3, 82
Denmark	11.00	11.00	11.00	11.00	11.00	11.00	10.00	10.00	Nov 30, 82
Finland	8.50	9.25	9.25	9.25	8.50	8.50	8.50	8.50	Jun 1, 82
Ireland	16.40	12.75	17.15	18.30	18.30	14.55	14.35	14.35	Dec 23, 82
Norway	9.00	9.00	9.00	9.00	9.00	9.00	9.00	9.00	Nov 30, 79
Spain	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	Jul 26, 77
Sweden	9.00	12.00	11.00	10.00	10.00	10.00	10.00	9.00	Jan 21, 83
Switzerland	2.00	3.00	6.00	5.50	5.50	5.00	4.50	4.50	Dec 3, 82
Argentina	89.90	87.01	98.50	99.87	87.23	128.54	128.54	128.54	Sep 30, 82
Korea	14.50	15.50	10.50	5.00	5.00	5.00	5.00	5.00	Mar 29, 82
New Zealand	13.00	14.00	13.00	13.00	13.00	13.00	13.00	13.00	Jul, 81
Philippines	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	May 19, 78
Singapore	6.75	10.50	9.50	7.00	7.00	7.00	7.00	7.00	Feb 19, 82
South Africa	7.00	7.00	13.50	13.50	13.50	13.50	13.50	13.50	Dec 15, 81
Venezuela	11.00	13.00	14.00	14.00	14.00	14.00	13.00	13.00	Sep 30, 82

Day-to-day money rates

monthly averages

	1979	1980	1981	1982							
	Dec	Dec	Dec	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
United States	13.78	18.90	12.37	14.45	14.15	12.59	10.12	10.31	9.71	9.20	8.77
Canada	13.83	15.61	14.53	15.22	15.55	16.16	15.03	13.58	12.10	10.91	10.63
Japan	8.02	9.49	6.70	7.17	7.19	7.19	7.18	6.99	6.92	6.68	6.95
Australia	7.84	9.51	12.84	15.51	15.01	13.39	15.09	13.23	13.27	12.52	11.04
United Kingdom	14.87	13.00	9.13	9.13	8.31	10.10	9.75	9.80	8.56	8.33	6.70
Belgium	10.65	9.68	12.78	12.95	11.68	13.13	11.76	10.52	11.13	10.51	9.43
France	12.17	10.87	15.46	16.41	15.98	15.05	14.58	14.11	13.91	13.18	12.88
Germany	9.15	9.13	10.65	9.08	9.00	9.03	8.74	7.96	7.48	7.02	6.07
Italy	16.00	17.50	20.63	20.50	20.41	20.13	19.69	18.63	18.63	18.86	19.00
Netherlands	15.67	8.37	10.67	8.87	7.63	8.94	8.63	7.33	7.23	6.13	n.a.
Austria	8.50	11.50	7.50	9.75	9.62	10.50	9.25	7.75	6.25	6.38	6.00
Finland	13.53	12.50	11.30	11.50	11.50	11.50	11.50	11.45	11.70	11.50	11.50
Ireland	16.88	13.31	16.88	19.25	18.94	18.25	15.62	16.00	13.13	15.50	14.54
Spain	9.61	16.74	18.73	17.84	22.34	17.29	13.96	13.78	20.54	23.18	20.30
Sweden	11.99	11.41	13.82	13.99	14.65	14.98	14.47	15.22	13.30	12.51	8.63
Switzerland	1.25	5.75	3.38	1.25	1.50	1.50	1.50	2.25	1.87	1.38	1.25
Argentina	78.22	70.84	84.93	91.51	74.82	60.72	101.34	127.09	135.66	132.70	155.32
Brazil	37.51	62.71	103.74	99.86	99.86	104.43	130.32	108.40	125.22	136.85	150.42
Hong Kong	14.19	14.05	10.75	14.75	13.50	11.75	8.25	9.37	11.05	11.13	9.13
Korea	15.00	14.82	14.40	12.00	13.35	13.39	13.23	13.39	13.58	13.75	13.84
Philippines	16.25	15.70	14.70	14.63	11.37	8.20	10.56	12.68	13.01	10.90	n.a.
Singapore	10.17	10.23	3.96	9.63	6.39	6.44	7.56	5.67	6.16	5.34	n.a.
South Africa	3.81	5.60	12.34	14.35	14.62	14.94	14.72	14.85	14.45	13.50	12.90
Eurodollars	14.41	19.22	12.29	14.63	14.13	12.57	10.10	10.52	9.88	9.40	9.15

Treasury bill rates

bond-equivalent yields, at or near end of month

	1979	1980	1981	1982							
	Dec	Dec	Dec	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
United States	12.39	14.87	11.90	12.00	13.15	10.63	8.01	7.64	8.13	8.10	8.15
Canada	13.66	17.01	14.41	15.18	16.33	15.25	13.70	12.73	11.21	10.72	9.80
Japan	5.68	5.93	5.42	5.42	5.42	5.42	5.42	5.42	5.42	5.42	5.42
Australia	9.31	12.17	13.27	14.88	15.47	14.61	14.43	11.62	13.72	12.98	9.39
United Kingdom	16.45	13.45	15.31	13.17	12.70	11.58	10.26	9.99	9.40	10.12	9.96
Belgium	14.40	12.75	16.00	15.00	15.75	14.50	13.75	12.75	12.75	12.25	12.25
Ireland	16.37	12.84	17.35	18.25	18.05	16.76	14.64	14.48	12.74	12.87	14.70
Italy	15.62	16.87	21.36	20.05	19.25	19.27	19.01	17.67	18.05	19.09	n.a.
Netherlands	12.75	8.00	9.75	8.75	8.19	8.75	7.38	7.00	6.50	5.88	n.a.
Spain	15.00	17.20	15.83	16.09	16.57	16.49	15.53	15.15	16.79	17.38	16.96
Sweden	9.74	12.87	9.20	9.22	9.22	10.25	10.25	10.26	10.26	9.20	8.18
Argentina	71.04	66.19	77.10	56.00	53.46	108.31	133.36	133.36	133.36	133.36	133.36
Brazil	31.68	110.60	110.21	110.52	112.91	122.71	131.87	135.53	132.91	132.91	n.a.
Korea	19.53	16.35	16.00	14.40	14.40	14.40	14.40	14.40	8.00	8.00	8.00
Mexico	17.89	27.73	33.22	43.52	51.30	53.01	55.88	49.72	43.02	n.a.	n.a.
New Zealand	11.25	11.25	11.25	11.25	11.25	11.25	11.25	11.25	11.25	11.25	11.25
Philippines	12.63	12.74	13.40	14.64	14.75	14.87	14.18	14.30	14.32	14.48	n.a.
Singapore	6.18	6.77	3.03	3.93	3.93	3.62	3.30	3.09	2.96	3.07	n.a.
South Africa	4.30	6.31	14.55	16.57	17.06	17.12	16.91	16.12	16.06	15.12	14.62

Representative money-market rates

bond-equivalent yields on major short-term (mostly 3-4-month) money-market instruments, other than Treasury bills, at or near end of month

	1979	1980	1981	1982							
	Dec	Dec	Dec	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
United States	13.70	17.62	12.78	13.58	15.19	11.98	9.61	10.26	8.68	8.68	8.81
Canada	14.15	17.50	15.25	15.90	17.20	15.70	14.20	12.95	11.65	11.00	9.95
Japan	8.01	9.80	6.30	7.08	7.19	7.02	7.22	7.05	6.89	7.06	6.90
Australia	10.30	13.00	16.00	18.25	19.10	16.95	17.00	14.10	15.50	13.80	10.65
United Kingdom	17.00	14.75	15.69	13.44	13.00	11.94	10.75	10.56	9.56	10.38	10.50
Belgium	14.45	13.10	16.00	14.75	15.75	14.75	13.90	13.00	12.85	12.50	12.35
France	12.62	11.56	15.25	16.13	14.87	14.87	14.38	13.81	13.06	12.94	12.75
Germany	8.70	10.20	10.50	9.15	9.40	9.30	8.30	8.00	7.33	7.25	6.20
Ireland	18.12	13.63	18.50	20.00	19.88	17.50	15.62	15.38	13.69	13.63	15.75
Italy	17.12	17.37	21.00	20.50	20.38	20.00	18.75	18.50	18.50	18.80	19.00
Netherlands	13.00	9.37	11.00	8.75	8.87	9.12	8.13	8.00	6.38	6.75	5.13
Spain	13.20	17.40	15.52	15.62	18.02	17.32	15.13	13.91	17.30	19.27	16.55
Switzerland	6.12	7.50	10.12	4.38	5.12	4.37	4.00	4.62	3.75	4.25	4.87
Hong Kong	14.37	17.69	14.18	14.75	14.25	12.75	10.75	10.00	11.00	11.25	10.13
Korea	19.53	16.35	15.69	12.50	8.00	8.00	8.00	8.00	8.00	8.00	8.00
New Zealand	16.00	14.25	16.05	17.30	17.25	17.25	17.50	17.75	18.00	17.25	16.75
Philippines	10.41	15.01	17.61	17.49	17.03	17.06	16.69	16.50	15.89	16.00	n.a.
Singapore	10.12	14.12	7.81	9.94	9.12	8.19	8.31	7.69	7.69	7.31	n.a.
South Africa	4.72	7.12	15.47	17.32	17.92	18.19	17.59	17.10	17.21	15.75	15.26

Commercial bank deposit rates

at or near end of month

	1979	1980	1981	1982							
	Dec	Dec	Dec	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
United States	13.55	16.25	12.62	13.00	14.25	11.00	10.10	9.75	9.15	8.70	8.25
Canada	14.05	17.00	15.20	15.80	17.10	15.60	14.05	12.85	11.60	10.95	9.85
Japan	8.37	9.00	6.50	7.03	7.24	7.20	7.35	7.30	7.27	7.15	7.00
Australia	10.25	12.71	15.65	18.16	18.25	16.64	17.51	14.69	14.96	14.56	10.20
United Kingdom	16.81	14.87	15.69	13.37	13.00	11.81	10.63	10.81	9.50	10.44	10.31
Belgium	14.50	12.63	15.50	14.37	15.12	14.38	13.13	12.75	12.50	12.25	12.25
France	12.50	11.25	9.16	9.60	9.40	8.97	8.75	8.53	8.43	8.19	8.24
Germany	7.75	8.00	9.50	8.25	8.50	8.25	7.00	7.00	6.60	6.50	6.00
Italy	13.25	13.25	13.25	13.25	13.25	13.25	13.25	13.25	13.25	13.25	13.25
Netherlands	13.50	9.50	11.00	8.75	8.75	8.87	8.13	7.88	6.38	6.75	n.a.
Austria	8.50	11.25	9.63	8.50	8.50	8.50	8.62	8.25	7.75	7.13	6.25
Denmark	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	9.00	9.00
Finland	4.25	5.00	5.00	5.00	4.25	4.25	4.25	4.25	4.25	4.25	4.25
Ireland	17.87	13.63	18.38	19.88	19.50	17.37	15.50	15.25	13.63	13.50	15.25
Norway	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00
Spain	4.50	4.50	11.78	12.19	12.06	12.02	12.44	12.33	13.04	13.03	n.a.
Sweden	8.75	9.75	10.25	9.50	9.50	9.50	9.50	9.50	9.50	9.50	9.50
Switzerland	4.75	7.50	8.75	3.25	5.25	3.50	3.50	3.25	3.00	3.00	3.00
Argentina	72.64	72.00	86.76	70.00	85.89	60.83	60.83	85.16	85.16	103.42	103.42
Brazil	55.55	96.49	110.05	108.50	109.15	113.90	99.00	103.18	107.53	122.51	118.26
Hong Kong	9.25	13.00	12.50	11.50	11.50	11.00	9.00	9.00	9.00	8.50	7.50
Korea	15.00	14.82	14.40	12.00	7.60	7.60	7.60	7.60	7.60	7.60	7.60
Mexico	16.75	26.15	31.81	40.86	48.05	50.60	53.29	49.75	45.32	n.a.	n.a.
New Zealand	15.90	13.50	15.50	16.50	16.50	16.50	16.50	16.50	16.50	16.50	16.50
Philippines	10.50	14.00	14.00	14.00	14.00	14.00	14.00	14.00	14.00	14.00	14.00
Singapore	10.31	13.19	7.50	9.31	9.00	7.75	8.00	7.31	7.00	7.00	n.a.
South Africa	4.82	7.87	14.75	17.05	17.75	17.87	17.17	16.50	16.53	15.18	15.25
Venezuela	15.00	16.00	14.75	15.50	15.50	16.00	15.50	14.50	15.00	15.00	15.50

Commercial bank lending rates to prime borrowers

at or near end of month

	1979	1980	1981	1982							
	Dec	Dec	Dec	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
United States	15.25	21.50	15.75	16.50	16.50	15.50	13.50	13.00	12.00	11.50	11.50
Canada	15.00	18.25	16.50	17.00	18.25	17.25	15.50	15.00	13.75	13.00	12.50
Japan	6.51	8.16	6.95	6.36	6.34	6.33	6.32	6.31	6.35	6.35	6.35
Australia	10.75	13.50	15.75	17.50	17.50	17.50	17.50	17.00	16.50	16.50	15.00
United Kingdom	18.00	15.00	14.50	13.00	12.50	12.00	10.50	10.00	9.50	10.00	10.00
Belgium	15.25	15.75	18.00	17.50	17.50	17.50	16.75	16.00	16.00	15.50	15.50
France	12.50	12.25	14.00	14.00	14.00	13.75	13.25	13.25	12.75	12.75	12.25
Germany	8.75	11.50	13.00	11.50	11.50	11.50	11.50	10.50	10.50	10.00	8.75
Italy	19.50	20.50	22.50	21.75	21.75	21.75	20.75	20.75	20.75	20.75	20.75
Netherlands	15.00	10.75	12.00	9.50	9.75	10.00	8.75	8.75	8.00	7.25	n.a.
Austria	8.50	12.50	13.50	13.00	12.25	12.25	12.25	11.50	11.50	11.75	11.75
Denmark	13.75	13.75	15.00	15.00	15.00	15.50	15.50	15.50	15.50	14.00	14.00
Finland	9.06	9.83	9.84	9.77	9.06	9.04	8.90	8.97	8.97	8.95	n.a.
Ireland	16.00	14.50	17.25	19.25	19.25	19.25	16.50	16.50	16.50	16.50	16.50
Norway	11.00	12.50	13.75	14.00	14.00	14.00	14.00	14.00	14.00	14.50	14.50
Spain	9.00	18.50	17.04	16.64	18.96	19.50	17.82	16.04	18.35	20.39	19.00
Sweden	10.75	11.75	13.50	12.50	12.50	12.50	12.50	12.50	12.50	12.50	12.50
Switzerland	5.00	5.75	8.00	7.50	7.00	7.00	6.50	6.50	6.50	6.50	6.00
Argentina	80.00	77.00	92.60	86.26	89.00	73.00	73.00	97.33	97.33	109.50	109.50
Brazil	59.60	96.45	138.09	138.89	141.04	143.19	151.80	151.80	151.80	162.30	166.40
Hong Kong	14.50	17.00	16.00	15.00	15.00	14.00	12.00	12.00	12.00	11.00	10.50
Korea	18.50	19.50	16.50	13.50	10.00	10.00	10.00	10.00	10.00	10.00	10.00
Mexico	19.00	24.25	31.81	36.26	39.59	43.23	46.42	47.88	45.99	45.51	n.a.
New Zealand	11.75	13.00	13.00	13.00	13.00	13.00	13.00	13.00	13.00	13.00	13.00
Philippines	16.00	16.00	18.00	18.00	18.00	18.00	18.00	18.00	18.00	18.00	18.00
Singapore	9.50	13.60	11.83	10.98	10.98	10.70	10.25	10.03	9.75	9.33	n.a.
South Africa	9.50	9.50	17.00	20.00	20.00	20.00	20.00	20.00	20.00	18.00	18.00
Venezuela	13.00	15.00	15.50	16.50	16.50	17.00	16.50	16.00	16.50	16.50	17.00

Domestic government bond yields

long-term issues, at or near end of month

	1979	1980	1981	1982							
	Dec	Dec	Dec	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
United States	10.20	11.46	14.33	13.57	14.14	13.68	12.46	11.50	10.79	10.74	10.61
Canada	11.32	12.69	15.27	14.72	16.03	15.62	13.96	13.48	12.63	12.18	11.69
Japan	8.63	9.04	8.32	8.31	8.64	8.49	8.41	8.46	8.50	8.32	7.76
Australia	10.08	13.00	15.00	16.50	16.50	16.50	16.25	14.50	14.25	14.40	13.00
United Kingdom	13.83	13.05	15.02	13.07	13.08	13.05	11.20	10.74	10.04	10.95	10.62
Belgium	11.13	13.04	13.99	13.56	13.59	13.13	13.13	13.20	13.23	12.87	12.66
France	12.59	14.31	16.44	16.13	15.98	15.96	15.78	15.76	15.81	15.79	15.40
Germany	7.91	9.19	9.71	8.83	9.33	9.14	8.79	8.00	8.27	8.19	7.90
Italy	14.00	16.23	21.39	20.77	20.78	20.77	20.11	19.18	19.38	19.84	n.a.
Netherlands	9.29	10.48	11.28	10.29	10.53	10.50	10.24	10.00	9.26	8.92	n.a.
Austria	8.20	9.62	10.37	10.03	10.01	10.01	10.04	9.59	9.24	8.99	n.a.
Denmark	18.28	19.98	20.91	22.58	22.78	22.29	22.72	22.83	21.16	20.81	20.14
Finland	9.58	10.42	10.98	11.12	10.84	10.74	10.59	10.64	10.62	10.68	n.a.
Ireland	16.64	15.63	18.28	18.28	18.58	17.33	15.93	15.17	13.95	15.53	n.a.
Norway	10.04	10.44	12.37	13.26	12.95	12.95	13.16	13.27	13.29	13.32	13.32
Spain	n.a.	n.a.	12.50	12.50	12.50	12.50	12.50	12.50	12.75	12.75	12.75
Sweden	11.22	12.61	12.80	12.79	13.00	13.18	13.23	13.27	13.73	13.09	13.01
Switzerland	4.20	4.63	5.40	4.98	5.19	4.90	4.64	4.43	4.31	4.27	4.22
Argentina	47.94	36.84	107.98	62.77	97.25	151.14	309.96	188.74	242.86	135.02	159.88
New Zealand	12.98	12.99	12.55	12.97	12.99	12.97	12.73	12.94	12.82	n.a.	n.a.
Philippines	13.20	13.40	13.41	13.41	13.41	13.41	13.41	13.41	13.41	13.41	13.41
South Africa	9.32	11.81	13.62	14.15	14.49	14.70	14.09	12.34	12.32	11.84	11.69
Venezuela	7.29	7.39	12.50	12.75	13.00	13.25	13.25	13.25	13.50	14.00	15.00

Domestic corporate bond yields

long-term issues, at or near end of month

	1979	1980	1981	1982							
	Dec	Dec	Dec	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
United States	10.75	13.00	15.50	15.00	15.75	15.25	13.50	12.88	12.00	11.75	11.75
Canada	12.07	13.62	16.46	16.82	17.80	17.27	15.99	14.78	13.61	13.58	13.05
Japan	8.34	8.60	7.70	7.42	7.90	7.90	7.99	8.05	8.10	8.10	7.55
Australia	11.65	14.25	16.50	17.50	17.50	17.75	17.50	16.75	16.75	16.75	15.00
United Kingdom	14.96	14.21	16.55	14.60	14.62	13.86	12.53	12.51	11.68	12.34	12.34
France	12.92	15.23	17.33	16.80	16.67	16.67	16.61	16.83	16.42	16.33	15.91
Germany	8.20	9.50	10.50	9.10	9.30	9.50	9.40	9.30	8.90	8.50	8.20
Netherlands	9.95	10.71	11.03	10.21	10.51	10.65	10.32	10.19	9.34	8.49	n.a.
Norway	10.53	11.24	13.36	12.40	12.90	12.90	14.14	14.94	14.46	11.69	14.13
Spain	14.20	14.82	14.76	16.72	17.98	17.42	17.86	18.36	17.90	17.33	n.a.
Sweden	10.21	11.95	12.94	12.91	12.87	12.90	12.92	12.97	13.16	13.33	13.37
Switzerland	5.53	5.63	6.60	5.82	6.05	6.05	6.12	6.08	5.96	5.89	5.92
Korea	27.80	28.20	27.00	17.10	16.40	13.90	14.00	15.00	15.30	15.90	15.90
Venezuela	14.55	16.15	17.00	17.75	17.75	18.00	17.50	17.50	17.75	18.00	18.00

J. P. Morgan & Co. Incorporated
23 Wall Street, New York, NY 10015
Morgan Guaranty Trust Company of New York
J. P. Morgan International Finance N.V., Curaçao, Netherlands Antilles
Morgan Community Development Corporation, New York
Morgan Holdings Corp., Wilmington
Morgan Bank (Delaware), Wilmington
Morgan Trust Company of Florida N.A., Palm Beach
Morgan Futures Corporation, New York, Chicago, London

Morgan Guaranty Trust Company of New York
23 Wall Street, New York, NY 10015

New York banking offices: 23 Wall Street, Fifth Avenue at 44th Street, Madison Avenue at 58th Street, Rockefeller Plaza at 50th Street

Banking offices abroad: Amsterdam (Bank Morgan Labouchere N.V.), Antwerp, Brussels, Buenos Aires, Düsseldorf, Frankfurt am Main, Hong Kong, London, Madrid, Milan, Nassau, Paris, Rome, St. Helier, Santiago (Banco Morgan Finansa), Seoul, Singapore, Taipei, Tokyo, Toronto (Morgan Bank of Canada), Zurich

Representative offices: Beirut, Caracas, Jakarta, Kuala Lumpur, Los Angeles, Manila, Mexico City, São Paulo, Sydney

Trust and investment offices and affiliates
The Morgan Bank: 9 West 57th Street, New York; London, Paris, Tokyo, Zurich
J.P. Morgan (Suisse) S.A., Geneva
J.P. Morgan Investment Management (Hong Kong) Ltd., Hong Kong
Morgan Trust Company of Florida N.A., Palm Beach

Subsidiaries
J. P. Morgan Interfunding Corp., New York
Morgan Guaranty International Bank: Miami, Houston, San Francisco, Los Angeles, Nassau
  Subsidiary: Morgan Guaranty International Bank (Cayman) Ltd., George Town
Morgan Guaranty International Bank (Bahamas) Ltd., Nassau
Morgan Guaranty International Finance Corporation: 37 Wall Street, New York, NY 10015
  Subsidiaries (wholly owned except as noted):
  Banco Morgan Finansa, Santiago *(50% owned)*
  Bank Morgan Labouchere N.V., Amsterdam *(50% owned)*
  J. P. Morgan Overseas Capital Corporation, New York
  J. P. Morgan (Suisse) S.A., Geneva
  J. P. Morgan Investment Management (Hong Kong) Ltd., Hong Kong
  Morgan Bank of Canada, Toronto
  Morgan & Cie S.A., Paris
  Morgan Guaranty Ltd, London
  Morgan Guaranty S.A.E., Madrid
  Morgan Guaranty Finance Limited, Hamilton, Bermuda
  Morgan Guaranty Pacific Limited, Singapore
  Morgan International Finance (Italy) S.p.A., Milan

Member: Federal Deposit Insurance Corporation. Printed in U.S.A.

Senator **Mathias**. Thank you very much, Mr. de Vries.

Mr. Solomon?

[Mr. Solomon's biographical data follows:]

Biographical Data of Robert Solomon

Robert Solomon is a Guest Scholar at the Brookings Institution and President of RS Associates, publisher of International Economic Letter.

He has a BA from the University of Michigan (1942) and a PhD from Harvard (1952). With the Federal Reserve Board from 1948 to 1976, he was involved in both its domestic and international activities. He became Adviser to the Board and Director of its Division of International Finance.

On leave from the Board, he was Senior Staff Economist at the Council of Economic Advisers in 1963-64. In 1972-74, he served as a Vice Chairman of the Deputies of the Committee on Reform of the International Monetary System (Committee of Twenty). He represented the Federal Reserve in Working Party 3 of the OECD for many years.

Mr. Solomon is now involved in a research program on policy-oriented international monetary issues at the Brookings Institution. He also writes a column for the Journal of Commerce, testifies before Congressional committees, and is an economic consultant.

He is the author of The International Monetary System, 1945-1981 (Harper & Row, 1982), a revised and expanded edition of a book first published in 1977. He has also published numerous articles in professional journals.

Mr. Solomon is an Officer in the French Legion of Honor and a recipient of the Rockefeller Public Service Award. He is a Member of the Group of Thirty, the Council on Foreign Relations, and a number of professional societies.

SELECTED LIST OF PUBLICATIONS

"Galbraith on Market Structure and Stabilization Policy," Review of Economics and Statistics, May 1958.

"A Note on the Full Employment Budget Surplus," Review of Economics and Statistics, February 1964.

"Balance of Payments Adjustment," Journal of Finance, 1969.

"The Allocation of Oil Deficits," Brookings Papers on Economic Activity, 1:1975.

"On the Past and Future of the International Monetary System," Columbia Journal of World Business, Fall 1976.

"International Monetary Scene," The Oriental Economist, November 1976.

The International Monetary System, 1945-1976: An Insider's View, Harper & Row, 1977.

"A Perspective on the Debt of Developing Countries," Brookings Papers on Economic Activity, 2:1977.

"Techniques to Control International Reserves," in Robert A. Mundell and Jacques J. Polak, eds., The New International Monetary System, Columbia University Press, 1977.

"The Case for Debt," The Banker (London), 1978.

The Interdependence of Nations: An Agenda for Research, National Science Foundation, 1977.

Book review: The Fate of the Dollar by Martin Mayer, The Financier, March 1980.

"The Debt of Developing Countries: Another Look," Brookings Papers on Economic Activity, 2:1981.

"'The Elephant in the Boat?': The United States and the World Economy," Foreign Affairs, Vol. 60., No. 3, 1982.

Book review: The Money Lenders by Anthony Sampson, The Financier, February 1982.

The International Monetary System, 1945-1981, Harper & Row, 1982.

Commentary on paper by Steven Kohlhagen in Jacob S. Dreyer, Gottfried Haberler, and Thomas D. Willett, eds., The International Monetary System: A Time of Turbulence, American Enterprise Institute, 1982.

"Power to What End?" Discussion of a paper by Susan Strange in Raymond E. Lombra and Willard E. Witte, eds., Political Economy of International and Domestic Monetary Relations, Iowa State University Press, 1982.

STATEMENT OF ROBERT SOLOMON, GUEST SCHOLAR, THE BROOKINGS INSTITUTION, WASHINGTON, D.C.

Mr. Solomon. Thank you, Mr. Chairman.

I have three points to put before the committee. Let me just summarize them to start with and then elaborate briefly.

The first one is that the debt of developing countries has not increased at an explosive rate and does not reflect generalized overborrowing.

My second point is that the recent difficulties of the major debtors have, to a large degree, been thrust upon them as the result of recession and high interest rates in the industrial countries.

And my third point is that in these circumstances the International Monetary Fund is playing a vital role and it is very much in the interest of the United States to support a substantial increase in the Fund's resources.

If you find some similarity between what I have just said and what you have heard from Mr. de Vries, that is purely coincidental. [Laughter]

Senator Mathias. No collusion.

Mr. Solomon. No collusion.

The raw statistics on debt tend to give an exaggerated impression of both the magnitude and the rate of growth of the debt of developing countries—and I am going to focus on the non-OPEC developing countries.

In my prepared statement there is a table 1. Line one of that table shows that in nominal terms the long-term debt of non-OPEC developing countries has quintupled since 1973. The usual figure used is $500 billion.

But we all know that the decade of the 1970's was a decade of inflation. If these debt data are corrected for inflation, as is done in line two of that table, you will see that the total increased by 145 percent rather than by 400 percent between 1973 and what is estimated for 1982. In other words, in real terms the debt of these non-OPEC developing countries increased about 10 percent a year.

It is also instructive to relate the growing debt of these countries to their expanding economic capacity. In relation to the exports of goods and services the debt of the entire group of non-OPEC developing countries rose from 89 percent to 109 percent. In other words, their export proceeds rose almost as fast as their debt during this period from 1973 to 1982.

And in fact, that ratio has declined a bit since 1978. In relation to the gross national product of the non-OPEC developing countries, the debt increased from 17 percent in 1973 to 24 percent in 1978 but has hardly risen since then.

Another way to assess the debt burden is to see how much of the export proceeds of the debtors must be used to pay interest. That is shown in line six of the table. For all non-OPEC developing countries that percentage rose from 4 percent to 9 percent.

So, I conclude from this look that for the totality of non-OPEC developing countries debt and the debt burden have not increased alarmingly.

We all know that debt is highly concentrated. Brazil and Mexico in particular account for a very high ratio of the total debt, and especially of the bank debt. I have some statistics for Brazil and Mexico in that table, as you can see. I will just run over the highlights very quickly.

These countries started off with a much higher ratio of debt to exports in 1973 than the totality of non-OPEC developing countries. For the two largest debtors, the ratio of debt to exports of goods and services has risen only a little bit faster than for all non-OPEC developing countries, as may be seen in lines 3a and 3b of the table.

It is noteworthy that after 1978 the exports of both Brazil and Mexico rose considerably faster than their debts, and therefore, the ratio of debt to export earnings fell sharply.

In relation to gross national product, the debt of Brazil and Mexico does not differ much in its magnitude or rate of growth from that of all other non-oil-developing countries. And their debt has not increased any faster than their gross national product since 1978.

Finally, as would be expected, the ratio of interest payments to exports of goods and services is much higher for Brazil and Mexico than for the average developing country. But since mid-1982, as interest rates have come down, that ratio has been falling and it would have fallen even more if the world economy were not in recession and the exports of these countries had grown at a normal rate.

The drop in interest rates from where they were in 1981 to the roughly 9 percent in the London inter-bank offered rate at present should—other things being equal—reduce Brazil's ratio of interest to exports of goods and services from the 0.29 shown in the table for 1981 to 0.16. Now, this interest rate drop we have had since midyear will have a big effect, and the same can be said for Mexico.

I conclude from this that even for Brazil and Mexico the debt does not appear to be an overwhelming burden.

I turn now to the impact of the events of the world economy. In the 1970's Brazil and Mexico—as well as Argentina and South Korea which are the third and fourth largest debtors of banks—Brazil and Mexico had a remarkable export performance. Mexico's exports in real terms rose at an average annual rate of almost 11 percent in the 1970's. Brazil's exports in real terms increased 9 percent per year in the 1970's.

Mr. Chairman, if I may say so, I presented these figures in greater detail in a paper I wrote a couple of months ago and if I may, I would like to submit that to the committee since it does provide further documentation for the generalizations that I have put in this statement.

Senator **Mathias**. It will be included as a part of your statement.

Mr. **Solomon**. Thank you, sir.

During the period when the exports of Brazil and Mexico rose so rapidly in the 1970's, the volume of world trade expanded less rapidly, 7 percent a year. The growth of world trade slowed to only 2 percent in 1980 and it did not increase at all in 1981.

To a large degree, the recent slowdown in world trade reflects stagnation or recession in the industrial countries whose nonoil imports rose in volume terms by only 1½ percent in 1980 and fell in 1981.

Meanwhile, the food and raw materials exported by many developing countries experienced a falloff in demand and their export prices dropped by more than 25 percent from mid-1980 to mid-1982.

In the first half of 1982, Brazil's exports of goods and services in dollar terms fell by 8 percent from a year earlier. Mexico's exports declined by 12 percent over that same period, reflecting the recession in the industrial world and the drop in raw material prices.

Meanwhile, as you know, interest rates on bank debt of these countries rose to unprecedented heights, much more than the rate of inflation. In other words, real interest rates rose to high levels.

For Brazil, the increase in interest rates from 1978 to mid-1982 added more than $4 billion to its annual balance-of-payments deficit on current account.

With their export earnings slackening and interest payments increasing, the largest debtors among developing countries began to restrain their own economic growth and to impose restrictions on their imports. Brazil's real GNP fell 3½ percent in 1981 and an estimated 2 percent in 1982. Mexico's GNP, which had increased 8 percent in 1981, decelerated sharply in 1982 and is expected to fall this year.

As these and other developing countries cut their imports, the exports of industrial countries decline and this, in turn, worsens the recession. We are in the presence of a vicious circle, reminiscent of the early 1930's.

This takes me to the role of the International Monetary Fund. Even though the developing country debtors restrained their economic growth and reduced their imports, their current account deficits remained large in the first half of 1982. The decline in interest rates in the second half of the year began to bring some relief but only after the Falklands incident and the difficulties in Mexico triggered the so-called debt crisis.

Bank credits to developing countries, which had increased nearly $12 billion in January–June of 1982, virtually came to a halt in the summer of last year. And questions arose as to whether banks would be willing to roll over or otherwise refinance maturing loans.

Clearly, countries with current account deficits are in no position to reduce their overall debt. They are not able to repay debt on net basis. Not only do they need to extend maturing debts, they need to receive new loans to finance their deficits.

In the absence of such financing, the debtor countries would have to slash their imports even more, thereby aggravating the world recession.

The International Monetary Fund took the leadership in seeing to it that what was in the interest of all parties came about. The Fund negotiated agreements with Brazil and Mexico under which it is lending to those countries and they, in turn, are adopting policy measures designed to reduce their balance-of-payments deficits.

These agreements provide the Fund's so-called seal of approval, which encourages private lenders. The IMF also saw to it in a more direct way that the commercial banks of the world extended new credits to these countries.

I believe that the recent actions of the IMF under the leadership of its Managing Director, M. de Larosiere, are of historic importance. The Fund is playing a role that no individual government and no private institution or group of institutions could play.

In these circumstances, it is very much in the interest of the United States to support and strengthen the International Monetary Fund. Without continued financing of the developing country debtors by the commercial banks and the Fund, American exports to these countries could fall further and recovery of the U.S. economy would be impeded.

Almost one-third of our exports go to the non-OPEC developing countries. That is considerably more than we sell to the European Economic Community. In the first 10 months of 1982, U.S. exports to all developing countries fell 6 percent; exports to Latin America fell 20 percent, and those to Mexico were down 21 percent. Similar reductions occurred in the exports of Japan and Western Europe to the developing countries.

The actions taken by the International Monetary Fund will not by themselves solve the debt problem. That will also depend upon policies that put the industrial countries' economies back on an upward growth path. A concerted effort to that end would be desirable and we learned yesterday that perhaps it will come about.

Meanwhile, the Fund's activities now and in the future will help the debtor countries to maintain their imports, thereby sustaining the world economy and keeping the recession from getting worse. That is obviously in the interest of the United States.

It has been charged by some that the Fund is merely, bailing out the banks. That is patently incorrect. As someone has said, the IMF is bailing in the banks by requiring them to increase their loans to the countries to which it is lending. None of the IMF credit is being used to repay bank debt.

Another argument that has been put forward against U.S. financial support for the Fund is that the squeeze on budget expenditures is depriving American citizens of Government services, and Congress in those circumstances cannot provide funds to foreigners.

The response to this argument is that support from the IMF will help to maintain U.S. exports, which in turn will maintain American jobs. I have never heard anyone of any political persuasion complain that U.S. exports are too high.

Mr. Chairman, this country can only gain by giving its full support to a substantial increase in the resources of the International Monetary Fund.

Thank you.

[Mr. Solomon's prepared statement follows:]

PREPARED STATEMENT OF ROBERT SOLOMON [1]

GLOBAL DEBT

In this statement, I shall present and try to document three main points concerning global debt, in the hope that this will assist the Committee in its later consideration of the Administration request for additional resources for the International Monetary Fund. I shall concentrate on the debt of developing countries, especially those that are not members of the Organization of Petroleum Exporting Countries (OPEC), since most of the current concern is about the debt of these countries.

---

[1] The views expressed in this statement are the sole responsibility of the author and do not purport to represent those of the Brookings Institution, its officers, trustees, or other staff members.

The three points I shall put forward may be summarized as follows: (1) The debt of developing countries has not increased at an explosive rate and does not reflect generalized overborrowing. (2) The recent difficulties of the major debtors have, to a large degree, been thrust upon them as the result of recession and high interest rates in the industrial countries. (3) In these circumstances, the International Monetary Fund is playing a vital role, and it is very much in the interest of the United States to support a substantial increase in the Fund's resources.

THE DEBT OF DEVELOPING COUNTRIES IN PERSPECTIVE

The raw statistics on debt tend to give an exaggerated impression of both the magnitude and the rate of growth of the debt of developing countries. The following table is designed to provide some perspective on the debt of non-OPEC developing nations as a group and on the debt of Brazil and Mexico in particular. It goes without saying that growing external debt is a normal condition for developing countries. As was true of the United States in the 19th century, developing countries absorb resources from abroad to supplement their domestic savings. In other words they incur deficits in the current account of their balance of payments, financed by capital inflow. This is a criterion for labeling a country as "developing" or "less developed."

It may be seen in line 1 of the table that, in nominal terms, the long-term debt of all non-OPEC developing countries has quintupled since the end of 1973. But the past decade has been an inflationary period. Prices in the industrial countries more than doubled between 1973 and 1982. When the debt data are corrected for inflation, as in line 2, we see that the total increased by 145 percent rather than 400 percent. In real terms, the debt expanded by just over 10 percent per year.

It is also revealing to relate the growing debt to the expanding economic capacity of the developing countries. In relation to their exports of goods and services (line 3), the debt of the entire group rose from 89 percent to 109 percent. In other words, export proceeds rose almost as fast as debt. Moreover, this ratio has declined a bit since 1978. In relation to the gross national product of the non-OPEC developing countries (line 4), debt increased from 17 percent in 1973 to 24 percent in 1978 but has hardly risen since then.

Another way to assess the burden of debt is to see how much of the export proceeds of the debtors must be used to pay interest. As is shown in line 6, this proportion has increased from 4 percent in 1973 to 9 percent this year.

Thus for the totality of non-OPEC developing countries, debt and the debt burden have not increased alarmingly.

But it is well known that the debt, especially debt to banks, is highly concentrated. As of mid-1982, Brazil and Mexico accounted for almost half of the bank debt of all non-OPEC developing countries. Moreover, the bank debt usually has floating interest rates; that is, interest rates on outstanding loans are adjusted every three or six months in line with the London interbank offer rate (Libor). Brazil and Mexico, along with the few other heavy borrowers from banks, are therefore vulnerable to rising interest rates in the industrial countries.

EXTERNAL DEBT OF NON-OIL DEVELOPING COUNTRIES [1]

[Dollar amounts in billions]

	1973	1978	1980	1981	1982
1. Total outstanding	$96.8	$276.4	$375.4	$436.9	$505.2
2. Total in 1973 prices [2]	$96.8	$161.8	$170.0	$205.6	[4] $237.7
3. Ratio of 1 to export proceeds [3]	.89	1.11	.93	1.03	1.09
a. Brazil	1.80	3.21	2.36	2.37	....
b. Mexico	1.42	2.64	1.61	1.74	....
4. Ratio of 1 to GNP	.17	.24	.22	.24	.25
a. Brazil	.15	.23	.23	.23	....
b. Mexico	.17	.30	.22	[5] .26	....
5. Interest payments	$4.6	$14.2	$30.1	$37.5	$40.8

EXTERNAL DEBT OF NON-OIL DEVELOPING COUNTRIES [1]—Continued

[Dollar amounts in billions]

	1973	1978	1980	1981	1982
6. Ratio of 5 to export proceeds[3]	.04	.06	.07	.09	.09
a. Brazil	.06	.21	.28	.29	....
b. Mexico	.07	.19	.18	[4].21	....

[1] Debt with an original maturity of more than 1 year.
[2] Deflated by export prices of developed market economies ("U.N. Monthly Bulletin of Statistics," July 1982, p. xxvi.)
[3] Exports of goods and services.
[4] Estimated by author.

Source: International Monetary Fund, "World Economic Outlook," 1982; World Bank.

If we look at Brazil and Mexico—the two largest debtors by far—we see that, in 1973, they had a higher ratio of debt to exports of goods and services than the average developing country (lines 3a and 3b). By the end of the 1981, these ratios had increased only a little faster for the two largest debtors than for all non-OPEC developing countries. It is noteworthy that, after 1978, the exports of both Brazil and Mexico rose considerably faster than their debt, and the ratio of debt to export earnings fell sharply.

In relation to gross national product, the debt of Brazil and Mexico does not differ much from that of developing countries in general, as is shown in lines 4. The debt of the two largest borrowers has increased no faster than their gross national product since 1978.

Finally, as would be expected, the ratio of interest payments to exports of goods and services is much higher for Brazil and Mexico than for the average developing country. That ratio has been falling again since mid-1982, as interest rates have come down. It would have fallen more if the world economy were not in recession, depressing the exports of both Brazil and Mexico. The drop in the Libor rate, from 16.78 percent in 1981 to 9 percent recently should, other things being equal, reduce Brazil's ratio of interest payments to export proceeds from .29 to .16. Similarly for Mexico.

Thus even for Brazil and Mexico, the debt does not appear to be an overwhelming burden.

IMPACT OF RECESSION AND HIGH INTEREST RATES IN INDUSTRIAL COUNTRIES

In the 1970's, Brazil and Mexico—as well as Argentina and South Korea, the third and fourth largest debtors of banks—had a remarkable export performance. Mexico's exports in real terms rose at an average annual rate of almost 11 percent from 1970 to 1979. Brazil's exports increased 9 percent per year. For Argentina the rate was near 11 percent and for South Korea an almost unbelievable 25 percent. In this period, the volume of world trade expanded at an average annual rate of 7 percent. It slowed to less than 2 percent in 1980 and did not increase at all in 1981.

To a large degree, the recent slowdown in world trade reflects stagnation or recession in the industrial countries, whose non-oil imports rose in volume terms by only 1.5 percent in 1980 and fell slightly in 1981. Meanwhile, the food and raw materials exported by many developing countries experienced a falloff in demand and their prices dropped by more than 25 percent from mid-1980 to mid-1982. Thus, while Brazil managed to increase its export volume by more than 20 percent in 1981, the dollar value of its exports rose by less than that and in the first half of 1982 fell by 8 percent from a year earlier. Mexico's exports declined almost 12 percent over the same period.

Meanwhile, interest rates on the bank debt of these countries rose to unprecedented heights. The Libor rate had averaged 8.85 percent in 1978, while consumer prices in industrial countries rose by just over 7 percent. The "real" interest rate was thus a little more than 1.5 percent in 1978. By 1981, Libor averaged 16.78 percent, with inflation at 10 percent. In the first half of 1982, Libor was at 15.30 while industrial-country inflation fell off to 8.2 percent, leaving a real rate of interest of more than 7 percent. This rise in interest rates added $2.5 billion to the interest payments Brazil had to make on the bank debt it had outstanding at the end of 1978. On its debt at mid-1982, the increase in interest rates from their 1978 level added more than $4 billion to its payments abroad.

With their export earnings slackening and interest payments increasing, the large debtors among developing countries began to restrain their economic growth and to impose restrictions on their imports. Brazil's real GNP fell 3.5 percent in 1981 and an estimated 2 percent in 1982. Mexico's GNP, which had increased 8 percent in 1981, decelerated sharply in 1982 and is expected to fall this year.

As these and other developing countries cut their imports, the exports of industrial countries decline and this in turn worsens the recession. We are in the presence of a vicious circle reminiscent of the early 1930s.

THE ROLE OF THE INTERNATIONAL MONETARY FUND

Even though the developing-country debtors restrained their economic growth and reduced their imports, their current-account deficits remained large in the first half of 1982. The decline in interest rates in the second half of the year began to bring some relief but only after the Falklands incident and the difficulties in Mexico triggered the debt crisis. Bank credits to developing countries, which had increased nearly $12 billion in January-June, virtually came to a halt in the summer of 1982. And questions arose as to whether banks would be willing to roll over or otherwise refinance maturing loans. Clearly, countries with current-account deficits are in no position to reduce their overall debt. Not only do they need to extend maturing debts; they need to receive new loans to finance their deficits. In the absence of such financing, the debtor countries would have to slash their imports even more, thereby aggravating the world recession.

The International Monetary Fund took the leadership in seeing to it that what was in the interest of all parties came about. The Fund negotiated agreements with Brazil and Mexico under which it is lending to these countries and they in turn are adopting policy measures designed to reduce their balance-of-payments deficits. These agreements provide the Fund's "seal of approval," which encourages private lenders. The IMF also saw to it, in a more direct way, that the commercial banks of the world extended new credits to these countries.

I believe that the recent actions of the International Monetary Fund, under the leadership of its Managing Director, Jacques de Larosière, are of historic importance. The Fund is playing a role that no individual government and no private institution or group of institutions could play.

In these circumstances it is very much in the interest of the United States to support and strengthen the International Monetary Fund. I would like to spell out the nature of this U.S. interest.

Without continued financing of the developing-country debtors by the commercial banks and the Fund, American exports to these countries would fall further, and the recovery of the U.S. economy would be impeded. Almost one-third of our exports go to the non-OPEC developing countries. That is considerably more than we sell to the European Economic Community. In the first ten months of 1982, U.S. exports to all developing countries fell 6 percent. Exports to Latin America declined 10 percent; those to Mexico were down 21 percent, and to Brazil, almost 9 percent. Similar reductions occurred in the exports of Japan and Western Europe.

The actions taken by the International Monetary Fund will not by themselves solve the debt problem. That will also depend on policies that put the industrial-country economies back on an upward growth path. A concerted effort to that end would be desirable. Meanwhile, the Fund's activities, now and in the future, will help the debtor countries to maintain their imports, thereby sustaining the world economy and keeping the recession from getting worse. This is obviously in the interest of the United States.

It has been charged by some that the Fund is merely "bailing out" the banks. This is patently incorrect. As someone has said, the IMF is "bailing in" the banks, by requiring them to increase their loans to the countries to which it is lending. None of the IMF credits are being used to repay bank debt.

Another argument that has been put forward against U.S. financial support for the IMF is that the squeeze on budget expenditures is depriving American citizens of government services and Congress cannot provide funds to foreigners at such a time. The response to this argument is that support for the IMF will help to maintain U.S. exports which in turn maintain American jobs. I have never heard anyone of any political persuasion complain that the United States exports too much.

This country can only gain by giving its full support to a substantial increase in the resources of the International Monetary Fund.

[Center for National Policy, October 1982]

THE INTERNATIONAL DEBT PROBLEM

(By Robert Solomon, Guest Scholar, The Brookings Institution)

Mexico's current inability to service its debts has heightened concern about the viability of the debts of developing countries in general. Large banks in the United

States, Europe, and Japan have a substantial amount of their resources invested in these countries and the possibility of a banking crisis has been widely discussed.

This paper examines the anatomy of the external debt of developing countries and the origins of the present problem, with the purpose of bringing out what needs to be done to deal with it while taking account of American interests.

Complex problems seldom have simple causes or simple solutions. Yet it cannot be over-emphasized that recession and high interest rates in the industrial countries are at the heart of the debt-servicing difficulties of the developing nations. Unless the industrial countries deal with these problems, the debt difficulties could become a generalized debt crisis.

THE GROWTH OF DEBT IN THE PAST DECADE

Just as the United States was a debtor country in the 19th century, developing countries are debtors today. In fact, one of the criteria by which one decides to label a country as "developing" is that it has a deficit in the current account of its balance of payments [1] and is borrowing abroad to finance it. Over time this leads to the accumulation of debt. Before the first oil shock, in late 1973, it was regarded as normal for the industrial countries as a group to have a current-account surplus and for the developing countries to have a matching deficit. The latter deficit was financed by a variety of capital flows from industrial countries either directly or through multilateral institutions like the World Bank. In the 1970s, a number of developing countries, especially those that have come to be characterized as "newly industrializing," began to borrow in substantial amounts from commercial banks in the industrial countries. (It is only since 1975 that data on such bank debt has been systematically compiled.)

The quadrupling of oil prices in late 1973 threw both developing and industrial countries into large current-account deficit while the OPEC countries moved into enormous surplus, estimated at almost $70 billion in 1974. In the years 1974–78 inclusive, the cumulative current-account deficit of the non-OPEC developing countries amounted to $145 billion. This deficit, plus an increase in official reserves of $42 billion, largely account for the $180 billion expansion in the long-term debt of these countries, which is shown in Table 1.

By 1978 the OPEC surplus had virtually disappeared, and balance-of-payments positions had returned to the pre-1973 pattern: the industrial countries as a group were back in current-account surplus and the non-oil developing countries were in deficit. This deficit was no larger in relation to the exports of developing countries than in the years before 1973.

Then the Iranian revolution led to the second oil shock and once again the OPEC nations move into very large surplus, estimated at $115 billion in 1980, while both industrial and non-oil developing countries has sizable deficits on current account. In the three years 1979–81, the non-oil developing countries incurred current-account deficits of about $210 billion. In addition to the higher cost of oil, other factors not present in 1974–78 tended to swell their deficits. Interest rates in industrial countries rose to unprecedented heights, and this added heavily to the debt-servicing burden. Moreover, recession in the industrial world not only depressed the volume of exports of many developing countries but led to a sharp fall in their export prices; from mid-1980 to mid-1982, world prices of food and raw materials fell 25 percent. In response to these deficit-increasing forces, many developing countries have acted in the past couple of years to restrict their growth and their imports. Last year was the first in a long while when the growth of developing countries as a group was no larger than the increase in their population.

Even so, the aggregate current-account deficit of non-oil developing countries came to more than 22 percent of their exports of goods and services in 1981, compared with about 15 percent in 1978 and an average of less than 18 percent in 1967–72.

The developments sketched out above led to a much faster expansion of the debt of non-oil developing countries after 1973 than in earlier years. The data on long-term debt—that with an original maturity of more than one year—are shown in Table 1.

---

[1] The balance of payments on current account is the surplus or deficit resulting from transactions in merchandise trade, shipping, insurance, travel, payments and receipts of interest and dividends and remittances by individuals and governments.

THE GROWTH OF DEBT IN PRESEPECTIVE

In nominal terms, the debt has increased enormously, quintupling from the end of 1973 to this year (end-1982 data are estimated by the International Monetary Fund). These raw numbers have inspired some of the newspaper stories that refer to the "crushing burden" and the "mountain" of debt of developing nations. It is necessary to put these numbers in perspective.

(It may be noted that these data, collected by the World Bank, include only debt with an original maturity of more than one year. Short-term debt probably amounts to somewhat more than $100 billion.)

TABLE 1.—LONG-TERM EXTERNAL DEBT OF NON-OIL DEVELOPING COUNTRIES [1]

[Dollar amounts in billions]

	1973	1976	1978	1980	1981	1982
1. Total outstanding	$96.8	$181.4	$276.4	$375.4	$436.9	$505.2
1a. To private creditors	$48.5	$99.2	$159.0	$220.0	$261.4	$305.7
Ratio of 1a to 1	.50	.55	.58	.59	.60	.61
2. Total in 1973 prices [2]	$96.8	$130.6	$161.8	$170.0	$205.6	[4] $237.7
3. Ratio of 1 to export proceeds [3]	.89	1.03	1.11	.93	1.03	1.09
4. Ratio of 1 to GNP	.17	.21	.24	.22	.24	.25
5. Interest payments	$4.6	$8.3	$14.2	$30.1	$37.5	$40.8
6. Ratio of 5 to export proceeds [3]	.04	.05	.06	.07	09	.09

[1] Debt with an original maturity of more than 1 year.

[2] Deflated by export prices of developed market economies ("U.N. Monthly Bulletin of Statistics," July 1982, p. xxvi.) 1982 figure estimated by author.

[3] Exports of goods and services.

[4] Estimated by author.

Source: IMF, "World Economic Outlook," 1982.

It must be remembered that the period since 1973 has witnessed a high rate of inflation. Prices in industrial countries more than doubled, in dollar terms, between 1973 and 1982. When the debt shown in line 1 of the table is corrected for inflation (line 2), it increased 145 percent rather than 400 percent.

It is also desirable to relate the growing debt to the growing economic capacity of the debtors. As may be seen in line 3, the debt of developing countries, as a ratio to their exports of goods and services, rose from about nine-tenths in 1973 to 1.1 this year. In other words, exports of goods and services increased almost as fast as debt. Moreover, this ratio has declined a bit since 1978. In relation to the gross national product of the non-oil developing countries (line 4), debt increased from 17 percent in 1973 to 24 percent in 1978, but has hardly risen since then.

Another way to judge the burden of the debt is to examine how much of the export proceeds of the debtors must be used to pay interest. As line 6 of the table shows, this proportion has increased from 4 percent in 1973 to 9 percent this year for all non-oil developing countries. As we shall bring out below, the interest burden is much heavier for a few of the larger debtors.

Thus for non-oil developing countries as a group, it appears that, although debt has certainly increased significantly, it has not explored. The raw numbers easily lead to exaggeration of the growth of the debt burden since 1973.

Yet it is important to take account of the distribution of the debt among countries and of differences in their dependence on bank debt. Of the total long-term debt of non-oil developing countries (leaving aside European countries such as Portugal, Turkey, and Yugoslavia, which are covered by Table 1), more than half is accounted for by seven countries: Argentina, Brazil, Chile, Mexico, Peru, the Philippines, and South Korea. It is these countries that are also heavy borrowers from commercial banks.

More generally, if there is a potential debt crisis that could cause significant problems for the world's financial system, it involves one or more of these countries. In fact, only Argentina, Brazil, and Mexico are large enough debtors to have the potential to create a general crisis. The other four countries mentioned above, along with all other debtors among non-oil developing countries, are too small individually to cause a serious systemic problem.

DEVELOPING-COUNTRY DEBT TO BANKS

Of the $180 billion increase in debt of all non-oil developing countries in 1974–78, as shown in Table 1, almost half was to private financial institutions, mainly commercial banks. In 1979–82, the corresponding proportion is estimated to be almost three-fifths. Furthermore the borrowing from banks is concentrated among a small group of the non-oil developing countries.

TABLE 2.—EXTERNAL BANK DEBT OF NON-OIL DEVELOPING COUNTRIES

[Billions of dollars; end of period]

	1975	1976	1978	1979	1980	March 1982
1. Total outstanding	63.0	80.9	120.8	155.6	193.3	230.3
Argentina	3.2	3.4	6.7	13.1	18.9	23.4
Brazil	14.8	21.2	31.7	36.9	43.3	50.3
Chile	0.8	1.1	2.7	4.5	6.7	9.9
Mexico	13.5	17.9	23.2	30.7	41.0	58.1
Peru	2.3	2.8	3.4	3.6	3.9	4.5
Philippines	2.0	2.6	4.0	5.4	7.0	7.5
South Korea	3.3	3.9	6.9	10.3	14.0	16.2
2. Subtotal	39.9	52.9	78.6	104.5	134.8	169.9
Ratio of 2 to 1	.63	.65	.65	.67	.70	.74

Source: Bank for International Settlements.

From the data in Table 2, it may be seen that three-fourths of the external bank debt of all non-oil developing countries is accounted for by seven nations. And 57 percent of that debt is owed by Argentina, Brazil, and Mexico. (These data cover bank debt of all maturities, whereas as noted earlier the data we have used thus far represent only debt with an original maturity of more than one year.)

The bank debt of these seven countries increased much faster after 1978 than did that of all non-oil developing countries. And particularly for Argentina, Brazil, and Mexico, debt to banks now comprises a very substantial proportion of total debt.

THE INTEREST BURDEN

Most of the bank debt carries floating interest rates. That is, the rate of interest is adjusted periodically—generally every three or six months—in line with the so-called London interbank offer rate (Libor) or sometimes with the prime rate in New York. The spread over Libor—the amount the borrower pays over the Libor rate—varies among countries and is regarded as a measure of the risk the banks attach to loans. For some time, new loans to Brazil have carried a spread of 2⅛ percent, whereas France recently arranged a syndicated loan with a spread of ½ percent.

The Libor rate has risen steeply in recent years, as shown in Table 3. Whereas in 1978 the interest rate exceeded the average inflaton rate in industrial countries by just over 1½ percentage points, this margin rose to more than 7 percentage points in early 1982. This is one measure of the very high real interest rates that prevailed in the United States and Europe until recently.

TABLE 3.—INTEREST RATES AND INFLATION, 1978–82

[Percent per year]

	1978	1979	1980	1981	1982			
					Q-1	Q-2	July	August
Libor	8.85	12.09	14.19	16.78	15.54	15.07	14.39	11.58
Inflation in industrial countries	7.2	9.1	11.9	10.0	8.5	7.9	7.4	7.0
"Real" rate of interest	1.65	2.99	2.29	6.78	7.04	7.17	6.99	4.58

Note.—Libor is London interbank offer rate on 3-month dollar deposits. Inflation is average increase, year over year, in consumer prices in 19 industrial countries.

Sources: International Monetary Fund, International Financial Statistics, October 1982.

By the third week of October the Libor rate had fallen to about 10 percent. With the measured advance in consumer prices in the United States at an annual rate of less than 5 percent, the real interest rate remains high.

Still, the fall in nominal interest rates must be bringing some relief to the heavy borrowers among developing countries. If it is assumed that most of the bank debt shown in Table 2 carries floating interest rates, each percentage point reduction in Libor reduces the annual interest burden of Brazil and Mexico by about $½ billion. The 6¾ percent drop in the past year thus lowers interest payments by about $3.25 billion for each of these countries.

But this relief does no more than begin to reverse the heavy increase in interest burden that took place after 1978.

TABLE 4.—TRADE BALANCES OF CURRENT-ACCOUNT BALANCES OF MAJOR DEBTORS

[Billions of dollars]

	1978		1979		1980		1981	
	T.B.	C.A.	T.B.	C.A.	T.B.	C.A.	T.B.	C.A.
Argentina	2.9	1.9	1.8	−0.5	−1.4	−4.8	0.9	−4.1
Brazil	−1.2	−7.0	−2.7	−10.5	−2.8	−12.8	1.3	−11.7
Mexico	−1.7	−3.1	−2.8	−5.5	−2.3	−7.5	−3.3	−13.0
South Korea	−1.8	−1.1	−4.4	−4.2	−4.4	−5.4	−3.0	−4.5

Note.—T.B. is trade surplus or deficit (−) with imports measured f.o.b. C.A. is current account surplus or deficit (−).
Source: International Monetary Fund, International Financial Statistics.

It can be seen in Table 4 that the difference between trade balances and current-account balances widened out significantly between 1978 and 1981. In the case of Brazil, the difference increased from $5.8 billion to $13 billion. Much of this must be the result of higher interest rates not only on debt outstanding in 1978 but on the extra debt incurred owing to the enlargement of the current-account deficit in reflection of the need to pay out more interest. The data in Table 5 show, for the major debtor countries, the proportion of export proceeds that go to pay interest on long-term external debt. This is a better indicator of debt burden than the conventional debt-service ratio, which measures principal as well as interest payments as a proportion of exports. Scheduled principal payments are often bunched and in a normal banking relationship they are rolled over without difficulty. At a time when the debtor's financial condition is under a cloud, such rollovers cannot, of course, be taken for granted. But for present purposes, it is preferable to measure debt burden as if conditions were normal. Below we consider crisis scenarios.

TABLE 5.—INTEREST PAYMENTS AS PERCENTAGE OF EXPORTS OF GOODS AND SERVICES

	1973	1978	1979	1980	1981
Argentina	5.3	9.6	10.1	13.5	17.3
Brazil	5.5	21.3	26.1	28.5	28.9
Chile	2.6	12.1	12.1	15.1	23.3
Mexico	7.1	18.3	20.5	18.3	21.0
Peru	7.1	17.9	13.3	12.4	15.9
Philippines	1.3	6.3	7.6	6.9	9.7
South Korea	5.5	4.0	4.8	6.0	6.9

Note.—Interest on debt with maturity of more than 1 year.
Source: World Bank, International Monetary Fund.

The percentages shown in Table 5 are so much above the averages in Table 1 mainly because the debt of these countries is largely to commercial banks and carriers much higher interest rates than the debt of the typical developing country.

What emerges from Table 5 is that the interest burden has assumed a large but not alarming proportion in the cases of Argentina, Brazil, Chile, and Mexico. Because Chile's bank debt is not big enough to create a serious systemic problem, we confine our attention below to the other three countries.

The percentages in Table 5 could be even higher in 1982, since export proceeds are not rising rapidly. On the other hand, the fall in interest rates should help. For the future, a resumption of a reasonable pace of expansion and lower real interest rates in the industrial countries would reduce these ratios.

Meanwhile, the heavy interest payments plus the desire to remain creditworthy have led these countries to adopt domestic policy measures aimed at curtailing domestic demand and imports.

THE ECONOMIC PERFORMANCE OF THE MAJOR DEBTORS

Most of the countries that have been heavy borrowers from banks in the past decade have an impressive record of economic performance. Their current difficulties in servicing debt reflect a liquidity problem rather than a problem of economic viability or solvency.

TABLE 6.—RATES OF GROWTH OF REAL GNP

Percent per year

	1970–79	1980	1981
Argentina	2.6	1.4	−6.2
Brazil	8.7	7.9	−3.5
Chile	2.8	6.5	[1] NA
Mexico	6.4	8.3	2.0
Peru	3.4	3.0	3.9
Philippines	6.6	4.4	3.8
South Korea	10.0	−3.6	8.0

[1] The Wall Street Journal, Oct. 4 1982, p. 36.

Source: IMF, International Financial Statistics.

From 1970 to 1979, the rate of growth of real output was substantial in Brazil, Mexico, the Philippines, and South Korea, as may be seen in Table 6. Argentina has the spottiest growth record but, until the late 1970s, its debt was small. Table 6 also shows the slowdown in economic growth and in some cases recession after 1979. As a result, Argentina, Brazil, and Mexico had surpluses in their merchandise trade in the first half of 1982.

TABLE 7.—RATES OF INCREASE OF EXPORT VOLUME

[Percent per year]

	1970–79	1980	1981
Argentina	10.7	NA	NA
Brazil	9.1	22.9	20.3
Chile	10.7	NA	NA
Mexico	10.9	NA	NA
Peru	1.7	NA	NA
Philippines	7.4	20.6	1.1
South Korea	25.3	10.9	18.2

Sources: IMF, World Bank.

Except for Peru, the expansion of exports of the heavy debtors was considerably faster than that of world trade in the 1970s (Table 7). For those few countries for which data on export volume are available for 1980 and 1981, the record is remarkable considering the slow growth of world trade in those years.

We turn now to the economic performance of the heaviest debtors.

Argentina.—Before 1980 Argentina's current-account deficit was small and in some years there was a surplus. In the past two years, capital outflows, on top of large current-account deficits, have required heavy borrowing as well as a sharp draw-down of foreign-exchange reserves.

The political and economic uncertainties were compounded by the Falkland Islands episode.

The policy performance does not give grounds for great confidence. But Argentina is favorably endowed by nature and its exports of animal products and grains have, over the years, kept its balance of payments relatively strong. Furthermore, Argentina produces one-half million barrels of oil per day and its annual oil imports are small.

Brazil.—Now a major exporter of manufactures, Brazil has had an economic performance that has been characterized by the word "miracle." From 1970 to 1980, its real GNP more than doubled and its export volume outpaced its GNP growth. Exports other than coffee—the latter accounted for only 6.5 percent of merchandise exports in 1981—more than tripled in the 1970s. Yet imports advanced only a little more than half as fast as exports. Brazil has thus been able to carry out import substitution but not at the expense of export growth. In fact, as Table 7 indicates, the volume of exports increased by more than one-fifth in 1980 and 1981. But the prices of many of Brazil's exports have fallen sharply.

The most recent data show that whereas the dollar value of exports in the third quarter of 1981 was 18 percent higher than a year earlier, those in the fourth quarter were up only 10 percent; in the first quarter of this year, exports were down more than 4 percent. The world recession is having its impact.

Concern over the balance of payments led the Brazilian authorities to impose restrictive economic policies in 1980, which resulted in 1981 in the first decline in real GNP on record. The volume of imports diminished 18 percent from 1979 to 1981. Of the $9 billion increase in the dollar value of imports in 1979-81, $7.1 billion was accounted for by petroleum, reflecting the sharp rise in the oil price in those years. Brazil's recession turned a trade deficit of $1.2 billion into a trade surplus of the same magnitude as the value of non-oil imports fell off. But, as noted, the current account was still in substantial deficit in 1981.

In the face of uncertainty over the availability of additional bank credits, the Brazilian government recently took further restrictive action, including a sharp curtailment of imports.

Mexico.—The "oil bonanza" made itself felt in the mid-1970s as Mexico became a net exporter of oil. In volume, Mexico's oil exports are ten times what they were in 1975. As foreign-exchange revenues from oil exports rose rapidly—from $1 billion in 1977 to $13.8 billion in 1981—investment expenditures were stepped up sharply, including those by the public sector.

Gross fixed capital formation increased, as a proportion of all uses of Mexico's resources (what economists call absorption) from 18.8 percent in 1973 to 20.9 percent in 1978 to 23.9 percent in 1980.

The investment boom produced a high rate of inflation and a shortage of skilled manpower. The inflation in turn created difficulties for the management of the exchange rate, which led to large capital outflows.

It seems evident that investment was increased too rapidly and was bound to cause disruptions in any event. But the oil glut has changed the outlook from one of rapidly expanding oil revenues to more or less stable revenues. The adjustment in the use of domestic resources, which would have been necessary anyway, has become imperative. A first step toward greater austerity was taken last April. It is safe to assume that further such steps are under discussion with the International Monetary Fund.

THE EXPOSURE OF BANKS

Of the $230 billion of bank loans outstanding to non-oil developing countries at the end of 1981, American banks accounted for 39 percent. It comes as a surprise to observe that the share of U.S. banks in the bank debt of Argentina, Brazil, and Mexico is also in the range of 38-40 percent. One would have expected relatively heavier involvement by American banks in Latin America, especially Mexico, than elsewhere.

The exposure of banks to country risk may be measured by loans to borrowers in the country in relation to the capital of the banks. At the end of 1981, the nine largest American banks had loans outstanding to Argentina, Brazil, an Mexico equal, respectively, to 20, 42, and 45 percent of their capital. Some individual banks have exposure ratios that are considerable higher. In the cases of Argentina and Mexico, the exposure has shot up recently, from 13 and 29 percent, respectively, at the end of 1979.

If one wanted to imagine a banking crisis, one could do so by conjecturing that Argentina, Brazil, and Mexico all go into default on their bank debt. This would throw the largest American banks into insolvency. (So would bankruptcy by ten American corporations to which the banks had loans outstanding equal to 10 percent of their capital.) Even rumors of default by one or more of these countries might lead large depositors—those not covered by deposit insurance—to withdraw funds and cash in certificates of deposit. This would amount to a run on the banks, creating a liquidity crisis rather than a solvency crisis.

These crisis scenarios are highly unlikely to materialize. The borrowing countries have a strong incentive to maintain their access to credit. And the U.S. Government showed its readiness to help when it quickly made $2 billion available to Mexico in August. Even if the large borrowers were to continue to have difficulty servicing debt, loans on the banks' books would not be written off overnight. If there were losses, they would first come out of the banks' earnings before impairing their capital. Write-offs, if it came to that, would take place only gradually.

As to bank liquidity, there is no evidence that banks are having difficulty in attracting deposits because of substantial exposure in Latin America. Two of the larger banks have had to pay higher interest rates than their competitors on certificates of deposit, but this is related to losses on domestic loans rather than to external exposure. Furthermore the differential between interest rates on commercial bank certificates of deposit and U.S. Treasury bills, which widened considerably in the summer has narrowed again in October. In any event, if banks did begin to experience liquidity problems owing to deposit withdrawal, the Federal Reserve can be assumed to be prepared to carry out its central banking function of lending to banks facing a liquidity drain based on fear. The prompt action of the Federal Reserve at the time of the Penn Central failure demonstrates its power to contain a liquidity crisis.

The danger of a banking crisis stemming from the difficulties of the major debtors in Latin America, while it cannot be ruled out, is not great. And the danger that does exist can be reduced by measures, desirable in any event, to bolster the flow of capital to the developing countries.

THE RISK OF A CREDIT DROUGHT

The process by which commercial banks financed a portion of the current-account deficits of developing countries in the past decade is commonly referred to as recycling. Particularly when the OPEC group was in substantial surplus, the banking system received OPEC's growing reserves as deposits and loaned the funds to countries with corresponding deficits. If such recycling had not occurred, the world economy would have been plunged into deep depression, as countries with greatly enlarged oil bills tried to reduce their current-account deficits. Now, although the OPEC surplus has virtually disappeared, the developing countries remain in large deficit for reasons set forth above. Recycling continues to be necessary.

Apart from the risk of a banking crisis, there is thus another risk to the world economy in the present state of concern about developing-country debt. The second risk is that the commercial banks will sharply curtail their lending to the countries that have been dependent on bank credits to finance their current-account deficits. The result could be drastic contraction in the economies of the debt-dependent countries, accompanied by steep reductions in their imports. This in turn would aggravate the recession in the industrial countries, with further repercussions on the developing world.

This process has already started. It was noted above that Brazil has imposed strict limits on its imports. Argentina's real GNP has fallen more than 10 percent since 1980 and its imports are declining. At the moment there is a near-freeze on imports into Mexico.

In the first seven months of this year, U.S. exports to all developing countries (including members of OPEC) fell almost 5 percent from the same period of 1981. Exports to Latin America declined 8.4 percent; those to Mexico were down 20 percent and to Brazil, 13 percent. These reductions in American exports to developing countries in general and to Latin America in particular occurred before the debit problem became acute in the summer of 1982. Since August, there apparently has been very little bank lending to Latin America. The severe limits on Brazil's and Mexico's imports were announced only recently.

The United States is hurt by such import cuts. Almost one-third of its exports go to non-oil developing countries. That is more than the United States sells to the European Economic Community—40 percent more in 1981.

The pressure on developing countries to limit imports has also had an impact on other industrial countries. For example, exports by both Germany and Japan to non-oil developing countries were down 10 percent or more in the first five months of this year from the 1981 level.

In these circumstances, with the industrial countries already in recession, a sharp fall in exports to developing countries increases the probability of a downward spiral in the world economy.

Yet, as we observed in our examination of Mexico, some developing countries have expanded at an unsustainable rate and have little alternative to slowing their rates of growth.

We turn now to what can be done to deal with these problems and dilemmas.

CONCLUSIONS: WHAT NEEDS TO BE DONE

The world economy faces a set of inter-related problems: sluggish output, if not recession, and too much unemployment; inflation still at an unacceptable level, though diminishing in many countries; real interest rates much too high in industrial countries; problems in servicing debt for a few countries that bulk large as borrowers from banks; and concern that the latter problem could create a banking crisis.

If these problems are to be alleviated, responsible action is called for by the major actors or groups of actors: economic policy-makers in both industrial and industrial countries; managers of commercial banks; officials of the International Monetary Fund; and legislators whose approval is needed for some of the necessary measures. Some of the actions require sacrifice by elements of the population of some countries. Others are a "positive sum game" in the sense that appropriate measures will make everyone better off.

It should be clear that, insofar as recession is concerned, there is a close interaction between industrial and developing countries. Recession in the former aggravates the debt problems of the latter. Moreover, if not enough is done to meet the financing needs of developing countries, they are forced to act in a way that reduces the exports of industrial countries, worsening their recessions.

Similarly, high real interest rates in the industrial countries not only discourage business and consumer spending within their economies but swell the current-account deficits of developing countries, which react by cutting imports and depressing the industrial countries even more.

The industrial countries, with unemployment at 30 million and rising, need to restore a healthy rate of economic growth for their own direct benefit. Beyond that, it is difficult to imagine that the developing countries will be able to cope with their debt problems unless the industrial countries act to move their economies out of recession and onto a reasonably rapid growth path.

We turn now to other actions needed to deal with the debt problem. Mexico exemplifies the point that some of the developing-country debtors have tried to do too much too fast. Changes in economic policies—already under way—will involve some painful adjustments. It is the function of the International Monetary Fund to work with the officials of such countries to evolve a set of agreed policies—referred to as Fund conditionality—that will enable them to achieve sustainable balance-of-payments positions while they use IMF resources to help finance their swollen deficits. As is well-known, the IMF seal of approval serves to encourage banks and others to continue to lend to countries.

It should not be assumed that all of the large debtors need to pull in their belts. Some, such as Brazil, have already done so. The conditions that the Fund sets on its lending should differ from one country to another depending on their current economic circumstances. This is only fair from the viewpoint of the potential borrowers. It also has importance for the countries with which these Fund borrowers trade. If too many countries are required to pull in their belts, sharply reducing their current-account deficits, their trading partners, both industrial and developing, will suffer reduced exports.

Meanwhile, the commercial banks have a stake in continuing to make new credits available to the developing countries, in addition to rolling over or refinancing maturing loans. It is not the responsibility of commercial banks to take a macroeconomic view and lend in order to prevent the world economy from falling further into recession. As discussed below, that responsibility belongs to governments and official institutions like the International Monetary Fund. Rather the commercial banks' interest is to keep their debtors solvent. Since current-account deficits could not be eliminated overnight even if that were tolerable in terms of the impact on the world economy, the debtors require continued financing.

It is reported that about a thousand banks from all parts of the world are involved in loans to Mexico. A large number are also undoubtedly lenders to Argentina and Brazil. Some of these banks, though they may realize that the debtors need continued financing to stay solvent, could well decide that their share in the total credits is so small that they could stay out of new loans or demand repayment. For this reason, among others, the health of the world economy calls for readiness by the International Monetary Fund to take on some of the lending role the banks have been fulfilling, should that become necessary. Such additional lending by the Fund, it should be stressed, would be for the purpose of enabling the developing countries to maintain a necessary level of imports, not for the purpose of "bailing out the banks." The banks are unlikely to receive net repayments. In fact, as observed above, most of them are likely, in their own interest, to advance additional credit.

Since the International Monetary Fund may have to take over a part of the role of the banks in lending to developing countries, does it have sufficient resources? It does at the moment, but these resources could become committed quickly if several large countries request assistance. It almost surely will have to replenish its resources before the next scheduled increase in the total quotas of its members. A substantial increase in these quotas deserves the support of the Administration and the Congress. But the quota increase will not become effective until 1985 at the earliest.

In the meantime, the United States has a direct interest in seeing to it that the Fund has ample loanable resources. The Fund needs such resources if it is to carry out its function of approving policy programs for debtor countries and, in the process, providing the seal of approval that encourages continued bank lending. It also needs financial resources if it finds it necessary to supplement bank lending as discussed earlier.

The Fund has the authority to borrow from member countries or from the markets. It can take up bank credits or issue securities. The United States should favor such borrowing by the Fund so that it can use its full powers, if and as necessary, to prevent a debt crisis.

Ample financing by the IMF is necessary in the circumstances faced by developing countries that are heavy debtors. But such financing, with its associated conditionality, will not by itself solve the debt problem. That also requires, as stressed earlier in this paper, a resumption of economic growth and lower real interest rates in the industrial countries. Otherwise, we could witness economic, and conceivably political, chaos in the debtor countries with inevitable harmful effects on the United States and the rest of the world.

Senator MATHIAS. Thank you, Mr. Solomon.

Mr. Heimann?

STATEMENT OF HON. JOHN G. HEIMANN, COCHAIRMAN, WARBURG PARIBAS BECKER, INC., FORMER COMPTROLLER OF THE CURRENCY, NEW YORK, N.Y.

Mr. HEIMANN. Thank you, Mr. Chairman.

I am delighted to be here and would also like to commend the article which appeared in the Washington Post yesterday. It said a lot of the things a lot of us would like to say but have not as articulately as put forth by you.

Senator MATHIAS. Thank you.

Mr. HEIMANN. I also agree wholeheartedly with some of the comments of my colleagues on the panel, and I shall not repeat them.

I was asked by the committee to concentrate more on some of the problems with respect to the commercial banks of the world. But I would like to support both Mr. de Vries and Mr. Solomon in noting that we cannot possibly solve the debt problem without real economic growth in the world. And we cannot have real economic growth in the world without real economic growth in the United States.

I would like to make a few general observations. One, that the financial systems of the world are inextricably intertwined, as noted by Senator Proxmire. There are approximately 500 banks involved in the rescheduling of Poland and well over 1,000 banks involved in Mexico.

Second, the financial institutions themselves individually have become internationally more integrated.

For example, the Midland Bank, one of the clearing banks in Britain, owns 57 percent of the Crocker Bank in the United States. It also owns 60 percent of the Montague Merchant Banking firm of which 40 percent is owned by the Aetna Life Insurance Co. of the United States, which just bought 100 percent of one of the largest investment counseling firms in this country. And this crosses hosts of boundaries.

Third, financial systems are based on confidence. It is the confidence of the deposit liability provider that his funds are safe and immediately available. If there is confidence that the banks and/or the banking system is secure—whether that be domestic or international—those systems or those institutions function smoothly.

If there is a doubt, this lack of confidence translates into a liquidity problem, the flight of deposit funds out of the bank or out of the system.

Fourth, there are banks, there are bankers, and there are banking systems and not all bankers, and not all banks, and not all banking systems are of the same quality. It is not only possible but probable that at any given time some bankers and some banks have made or are making mistakes. That does not inevitably translate into a weak or failing banking system.

A dynamic and healthy banking system can and should tolerate banks in need of improvement, or in fact disappearance for that weeding-out process of a competitive system has enormous systemic value if the weak are diminished in a controlled atmosphere and supplanted by stronger, better managed, institutions.

And finally, my last general observation is that governments do not exist to bail out banks. The ideal system is one in which the better-managed institutions succeed and those who falter—for whatever reasons—disappear. This can be managed without crises or chaos.

The mechanisms to permit the rational performance-driven transition exist and have been implemented in most nations. Bad bankers should not be permitted to continue bad banking. The shareholders of such institutions should bear the penalty. The system in the United States has functioned along these lines and has functioned effectively since the post-World War II period.

Financial institutions fail for two reasons: solvency—simply put, they go broke—where their assets are worth less than their liabilities or, second, the suppliers of deposit liabilities believe that the institution is broke—whether it is broke or not. They believe it, and since they believe it they withdraw their funds to the point at which the institution is unable to meet its obligations—a liquidity crisis.

Sometimes solvency and liquidity are linked, sometimes they are not. The solvency problems are like a wasting disease for they take years to develop and years to cure. The banking crisis of the 1930's was a solvency crisis, predicated upon worldwide deflation.

Liquidity problems are more like a high fever. They strike quickly and they must be cured immediately. And a liquidity crisis may create a solvency crisis when there was no inherent solvency crisis in the first instance.

Therefore, liquidity crises must be managed in order to permit sufficient time to discover actual solvency conditions.

Now, the definition of solvency is made by two judges. Perhaps the most important is the judgment of the public, the providers of deposit liability. If they decide a bank or banking system is insolvent, they withdraw their funds.

The second arbitrator is Government. Govermental supervising agencies may well decide an institution is insolvent, even though the public continues to provide deposit liabilities. And Government definitions of solvency can and have been changed to meet the circumstances of the times.

Recent actions on the part of the U.S. Congress and the Federal Home Loan Bank Board with respect to the savings and loan associations in this country are but one most obvious example of Government dealing with a solvency problem and resolving the solvency problem which was not created by a liquidity crisis.

Therefore, the present problems of the international banking system in my view can be managed if we, first of all, truly understand how the systems function and why they function the way they do.

Second, if those responsible for financial supervisory systems behave reasonably.

Looking at the question then first of solvency, I will not dwell on that at any greater length except once again to commend the points of my colleagues and one I would like to make, which is simply that the debt problem can only be solved by real economic growth in the world—and that is the fundamental solvency issue not only of the nations but of the banking systems that have lent to those nations.

As far as liquidity is concerned, the high fever, the immediate impact which can create the ripple effect through the markets of the world, it seems to me that the central banks of the industrialized nations need to provide a more precise understanding of their role and responsibility to provide liquidity for their own domestic institutions or, to put it another way, the 1974 Basle Concordat of the Board of Governors of the BIS needs to be made more explicit.

Whereas central banks can be suppliers of liquidity to their domestic banking institutions, the importance of the role of the International Monetary Fund providing bridge liquidity to countries—as mentioned by Mr. Solomon and Mr. de Vries—is important to complement the requirements of action on the part of central banks in the industrialized nations.

A strengthened IMF, whether it is through emergency fund borrowing—and I was delighted to read the reports of the meeting in Paris—an increase in quota, or private market borrowings, also provides a credibility factor for private banking institutions who, as Mr. Solomon has pointed out, are being required to go in convoy with the IMF in helping straighten out some of the financial problems of the LDCs.

In effect, it is a convoy of confidence that the private banker can justify increasing for continuing his loans if he knows in fact and indeed there is a multilateral agency that has policing powers, armed with conditionality, that can in fact and indeed address some of the problems of the individual nations in a global framework.

On matters of rescheduling—the point that was made in your article, Senator—it is clear that the economic and financial management of the LDCs needs upgrading, better controls, better numbers, and this all can be achieved through IMF conditionality.

Furthermore, in reschedule situations there must be increased harmonization on the part of the international supervisory agencies regarding debt classification and provisions for losses. To put it another way, if you accept the reality that the banking systems of the world are interrelated, then individual actions by individual nations with respect to specific problems must be better coordinated than they have in the past because the banks to which it applies are competing one with the other across the board.

The time has come also, I believe, for a re-evaluation of the methodology of rescheduling which, as you well know, is now fixed by calendar.

The normal way, "*x*" number of years, debts paid back on certain terms. It seems to me it should be more closely attuned to the earning power of the debtors, particularly those that are totally affected by exports of commodities over the prices of which and the demand for which, they have no control.

On the private banking system I believe that the private banks of the world must accept the logic of the need for loss provisions in rescheduling situations. To argue that there is no loss, I believe, is specious. Bankers would do better to recognize that a mistake has been made then to pretend that all is well. This is argued in great detail in the Group of 30 paper, "Risks in International Banking," which I submitted with my testimony.

Second, rescheduling has to be handled at a higher level in many banking institutions because the matters with which the institutions are dealing transcend merely the repayment of a loan, but have an effect on the total international system. And within the same banking institutions, I believe, there needs to be better management of foreign credit exposure and more attention paid to cost control.

Finally, there needs to be, in the long run, a better balance between the private banking institutions and the multilateral agencies, as touched upon by Mr. de Vries. The approach to the problem is an incremental one. I do not see any one solution that will solve the entire problem.

Finally, just to comment on one other point, and that is that we are in a situation which will take a great deal of effort and thoughtful evaluation by all of the parties involved. But it certainly seems to me that everybody who has been part of the problem ought to be part of the solution or, to put it another way, this concept that this is the problem of the large banks and not the small banks and/or that the small bank should be permitted out because it "did not know what it was doing in the first place," I consider that a rather specious line of reasoning.

I think the smaller banks who decided to participate in the international arena have the responsibility to stay in until the problem is solved, then they can opt to withdraw.

Thank you very much.

[Mr Heimann's prepared statement follows:]

PREPARED STATEMENT OF HON. JOHN G. HEIMANN

My name is John G. Heimann. I am co-chairman of the management committee of the international investment banking firm of Warburg Paribas Becker. From 1977 to 1981, I served as the 24th Comptroller of the Currency of the United States and from 1975 to 1977 as Superintendent of Banks of the State of New York. I am honored that the Committee on Foreign Relations has asked my views on the subject of global debt.

THE WORLDWIDE ECONOMIC RECESSION

We are in the fourth year of a worldwide economic recession. There are 30 million unemployed in the OECD nations. Forty percent of OECD export of goods and services are purchased by the less developed countries (LDCs). In 1981, of the $234 billion of U.S. exports, 38 percent were purchased by the developing countries—more than the combined U.S. exports to the EEC (22 percent) and Japan (9.3 percent).

Due to the worldwide recession, LDC income has been falling as their exports to the industrialized nations have diminished. This is coupled with the highest real interest rates since 1921. The result: substantial LDC balance of payment deficits.

If we do not have a real worldwide economic recovery, the problems of the LDCs will become even more acute. There will be further declines in LDC imports, thus creating additional economic problems for the industrialized nations. Unemployment will continue to increase, with a corresponding escalation in social and political pressures for stronger and more rigid protectionist policies. Protectionism as solution to world economic problems has had a dismal history. It has not worked in the past, there is no reason to believe it will work now.

The problems of the international financial system are symptoms of the decline in international real income growth. The economic difficulties of the LDCs will not be solved until worldwide-real growth is achieved. Financial systems, particulary the banking sector, reflect the economic health or weakness of the customers they serve. This is as true for a small country bank that serves a community dependent upon the sale of wheat as it is for the multinational bank that serves the world. The banking problem, such as it is, will not be solved until the economic problems of the free world are resolved.

THE LDC FINANCIAL CRISIS

The total external debt of developing countries climbed 18 percent in 1982 to $626 billion. The LDC financial situation results from mounting external debt and an inability to meet short-term maturities. In 1982, all LDCs paid more in principal and interest than their entire exports of goods and services. Interest payments alone were between 30–45 percent of exports.

According to the OECD, "for most of the 1970's, the real burden of debt and debt service was being eroded by inflation; it is now being radically increased in the context of economic stagnation." The OECD notes a sharp increase in debt service obligations, due to a growing reliance on commercial bank loans and the proliferation of floating-rate loans. Third world borrowers face a crunching debt service that will rise 20 percent to $131.3 billion.

Of the total LDC debt, approximately 60 percent is owed to the world's commercial banks. In 1982, the LDCs required $100 billion to cover their current account deficit and they will require approximately the same in 1983. Some $50–$55 billion of this amount will be supplied by official sources, but the remaining $45–$50 billion must be provided by private lending institutions.

Assuming it is in the self-interest of the industrialized nations (which I believe it clearly is) to prevent the LDCs economies from slipping into further weakness, this $45–$50 billion gap must be met through the participation of the world's private banking system.

GENERAL OBSERVATIONS

1. The financial systems of the world are inextricably intertwined. The growth of the Eurodollar market, the expansion of the world's banks into countries other than their own, and the rapid evolution of international telecommunications systems have all contributed to a worldwide financial system.

We have, in fact, a global debt market. Of the top 300 banks in the world, the United States represents approximately 25 percent of all assets, almost matched by Japanese banks and Western Europe accounts for 47 percent. Total loans to foreign countries by private banks of the United States, France, Britain, Luxembourg, West Germany, the Netherlands, and others total approximately $1.4 trillion, of which the United States holds 27 percent. Loans to LDCs, excluding OPEC nations, approximated 33 percent of U.S. bank's exposure, 23 percent for both France and Britain and 36 percent for West Germany (if their Luxembourg subsidiaries are included).

Another example of the interlinked international banking system is the striking reality that over 500 banks were lenders to Poland and well over 1,000 to Mexico.

2. The financial institutions themselves have become internationally more integrated. These relationships cross national boundaries in a variety of ways, linking more closely the financial systems of the world. This has become possible due to the advances in telecommunications technology which permit instantaneous worldwide transmission of information.

3. Financial systems are based on confidence i.e., the confidence of the deposit liability provider that his funds are safe and immediately available. If there is confidence that the banks and/or banking system are secure, whether domestic or international, they function smoothly. If there is a doubt, this fact of confidence translates into a liquidity problem: the flight of deposit funds out of a bank of banking system.

4. There are bankers, there are banks, and there are banking systems. Not all bankers, not all banks and banking systems are of the same quality. It is not only possible, but probable, that at any given time, some bankers and some banks have made or are making mistakes. That does not inevitably translate into a weak or failing banking system. A dynamic and healthy banking system can and should tolerate banks in need of improvement. The "weeding out" process of a competitive system has enormous systemic value, if the weak are diminished in a controlled atmosphere and supplanted by stronger, better managed institutions.

5. Governments do not exist to bail out banks. The ideal system is one in which the better managed institutions succeed and those who falter, for whatever reason, disappear. This can be managed without crisis or chaos; the mechanisms to permit the rational "performance-driven" transition exist and have been implemented in most nations. Bad bankers should not be permitted to continue bad banking. The shareholders of such institutions should bear the penalty. This system in the United States has functioned effectively since the end of World War II.

THE FAILURE OF FINANCIAL INSTITUTIONS

A financial institution fails for two reasons: They are broke—the simple definition of solvency—wherein assets are less than liabilities: Or, second, the suppliers of deposit liabilities believe that the institution is broke (whether it is or not) and withdraw their funds to the point where the bank is unable to meet its obligations: a liquidity crisis. Sometimes the two are linked; sometimes they are not.

Solvency problems are like a wasting disease for they take years to develop and years to cure. The banking crises of the 1930's was a solvency crisis, predicated upon a worldwide deflation. Liquidity problems are more like a high fever. They strike quickly and must be cured immediately. And a liquidity crisis can create a solvency crisis. Therefore, liquidity crises must be managed in order to permit sufficient time to discover actual solvency conditions.

Recently, there has been an unfortunate tendency on the part of some observers to add total LDC exposures of the world's banks and subtract this sum from the net worth of these institutions. This analysis presumes all loans to all LDCs as a total loss. Some portion of these loans may well have to be written off and should be. But, how much? over what period? how does one calculate real loss? To equate total exposure to total loss is not bourne out by historical experience. Furthermore, banking systems are able to adjust for virtually all conditions—other than massive deflation—given time to absorb actual losses.

Definitions of solvency are determined by two judges. Perhaps the most important is the public, defined as the providers of deposit liabilities. If they decide a bank or system is insolvent, they will withdraw their funds. The second arbitrator is government. Governmental supervisory agencies may well decide an institution is insolvent even though the public continues to provide deposit liabilities. And governmental definitions of solvency can and have been changed to meet the circumstances of the times.

Recent actions on the part of the United States Congress and the Federal Home Loan Bank Board with respect to the Savings and Loan Associations are but one most obvious example of government dealing with a solvency problem which has not been created by a liquidity crisis.

In my view, the present problems of the international banking system can be managed if (1) we understand how financial systems function, and (2) if those responsible for financial system supervison behave reasonably.

SOLUTIONS

"To every human problem there is a solution which is simple, neat, and wrong!" H. L. Mencken.

The problem facing the world is multi-faceted. There is no single solution. Rather, there are a series of solutions which address the interrelated problem affecting the world economy and the world financial system.

LIQUIDITY

The central banks of the industrialized nations need to provide a more precise understanding of their role and responsibility to provide liquidity for domestic institutions. The 1974 Basle Concordat must be made more explicit.

Whereas central banks can be suppliers of liquidity to their domestic banking institutions, the LDCs must have a liquidity bridge which will provide them with the necessary time to reorganize their domestic economy. This requires substantially enhanced support for the International Monetary Fund through a combination of quota increase, emergency fund borrowings (GAB), and private market borrowings.

A strengthened IMF provides credibility for private banking institutions. Since it is obvious that private resources must be channeled to the LDCs, this will be more easily accomplished if the responsibilty for financing LDCs activities is shared by the IMF and private banking institutions. A stronger IMF is an absolute requirement to support partnership with private banks. What the private bankers of the world need is a convoy of confidence. During these difficult times, increased exposures to LDCs can be justified only if there is a strong and credible program for the borrowing nation; a program which only can be implemented and policed by the IMF. Speed is of the essence. Commitment by the United States and the other industrialized nations to an enhanced IMF program, is an absolute must if the free world is to have sufficient time to permit the benefits of real economic growth to assist in the revitalization of the LDCs.

RESCHEDULING

1. The economic and financial management of LDCs need considerable upgrading. Programs which will insure better borrower controls are necessary. This can be achieved as a part of IMF conditionality.

2. In rescheduled situations, increased harmonization by international supervisory agencies regarding debt classification and provisions for losses, need to be agreed upon and implemented. Though there are vast differences in rescheduled situations, it cannot be argued that there is no loss component. Even though the loss component will vary, the banking supervisors of the industialized nations should come to common agreement as to their individual requirements or loss provision and/or loan write-offs.

The controversial suggestion is that provisions for losses should accompany any rescheduling. Even though such loss provisons should be absorbed over a period of time, this suggestion is the correct method to insure diligence and prudence by private bankers in their sovereign lending. This point of view is argued in the Group of 30 report "Risks in International Bank Lending" (appended).

3. The time has come to re-evaluate the methodology of rescheduling. The present technique is fixed by calendar. A program of rescheduling should be more closely tied to the LDC export earnings—so that debt repayments are more closely attuned to earning capacity. Obviously, this would require a close examination of foreign exchange, domestic budgets, and the like, all of which can be part of IMF conditionality.

THE PRIVATE BANKING SYSTEM

1. The private banking system of the world must accept the logic and need for loss provisions in rescheduled situations. As noted previously, this would be phased in over time. But to argue that there is "no loss" is specious. Bankers would do better to recognize that a mistake had been made than to pretend that all is well.

2. Rescheduling activities must be managed at a higher level within private banking institutions. More attention must be given, not only to the details of rescheduling, but also as to the fundamental social and political impact of such reschedul-

ings. Decisions of this nature cannot be delegated to junior officers; they must be made at the highest level within the private banking organization.

3. Within any banking institution, there needs to be a better management of credit exposures and more attention paid to cost control. It is my own view, that in the next five years the successful bank will be the one which concentrates on these factors rather than on asset expansion. For example, loan margins to higher risk countries must be increased. It is difficult to find profitability in an LDC loan priced at three-eights percent over the LIBOR rate, except perhaps for the syndicate manager.

4. Good banking is risk management, not risk aversion. However, the pressure of competition should not lead to increased risks, nor should faulty management systems reward the imprudently competitive loan officer.

5. Each bank that has helped to create the global debt problem has the responsibility to be part of the solution. I do not accept the theory that this is not the problem of the smaller bank. Any bank that participated in the international area has the responsibility to remain a participant until the problem recedes. If any withdraw at the present time, they will not only increase the problem for the larger banks, they will have abdicated responsibility.

6. There needs to be a better balance between the private banking institutions and the multi-lateral agencies. A need for greater cooperation and understanding is an absolute necessity.

7. The approach to the problem is incremental. It took many years to create the current situation. The resolution will also stretch out over the next three to five years. Suggestions for one-shot, all-healing solutions, while dramatic, are unnecessary.

THE SOLVENCY ISSUE

The long range solution to the problems of the LDCs and the international financial system is a return to worldwide real economic growth. This is not for the benefit of banks. It is for the benefit of people and the quality of their lives.

For there to be a worldwide economic recovery, it must be led by the United States. We are the economic locomotive. While it is not the purpose of these hearings to discuss the American economic situation, we will not find a solution to the problems of the financial system without recognizing that real economic growth in the United States is the primary need.

GROUP OF 30

Risks in International Bank Lending

Group of Thirty, New York, N.Y.

GROUP OF 30

Group of Thirty

The Group of Thirty was established in December 1978, to explore basic problems in the functioning of the international economic system. It meets twice a year, for two to three days at a time. Between these meetings, study groups and researchers gather material to serve as a basis for the Group's discussions.

GROUP OF THIRTY

Risks in International Bank Lending

First Report of the International Banking Study Group
of the Group of Thirty

Geoffrey L. Bell
John G. Heimann

Peter Cooke
Otmar Emminger
Rainer Gut
Leland S. Prussia

Edmond J. Safra
Henry Wallich
Dennis Weatherstone
Malcolm Wilcox

Executive Secretary: C.F. Muckenfuss
Study Coordinators: Judith A. Walter
Steven J. Weiss

Published by

Group of Thirty®
New York
1982

Risks in International Bank Lending

Introduction

The purpose of this study is to discuss the greater risks that may have arisen in the course of the rapid growth in international bank lending during the 1970s and to make suggestions aimed at strengthening the capacity of the system to manage those risks.

The report is the work of a study group on international banking that was established by the Group of Thirty in mid-1980. The establishment of the study group reflected a perception by the Group of Thirty that the growing integration of national banking systems combined with the rapid expansion of bank lending across national borders raised a wide range of issues both for banks and banking supervisors — issues that had not been fully explored.

At their broadest, the Group of Thirty's concerns may be expressed as follows: has growing integration brought with it a loss of control? This question immediately raises many others: are the risks involved in international bank lending — and the funding of that lending — different in kind, or only in degree, from the risks inherent in all banking activity? Has it created new problems that are not readily manageable by banks or individual banking authorities working alone? Should banks be left wholly free to decide for themselves, for example, the degree to which they should "borrow short and lend long"? Or the extent to which they should finance countries' balance of payments deficits? How far-reaching would be the implications of a default by a major borrowing country, or a collapse of a large bank? Are existing arrangements for 'risk containment' adequate?

Such were the range of questions which the study group was asked to address. In raising the issues in this way, the Group of Thirty did not mean to imply that it believed that international banking had suddenly become more risky. The Group recognized that the banking system had performed its "recycling" role in a remarkably smooth fashion, and without major mishap. Equally, the Group recognized that banking supervisors were themselves examining issues raised by the growth of international bank lending, and were monitoring developments in this field. At the same time, the Group believed that a study conducted by practicing bankers in cooperation with banking supervisors and others with wide experience in this field could make a distinctive contribution to public discussion and understanding of these issues.

As background for its deliberations, the study group commissioned a review of existing literature on international banking supervision and risk and some original analysis of selected topics, much of which took the form of papers specifically prepared for study group meetings. The bibliographic search and many of the analytic studies were undertaken by research staff of the U.S. Office of the Comptroller of the Currency (OCC). (Two such studies are appended to this report.) Direction and oversight of the background efforts were carried out by the Study Group's executive secretary, C.F. Muckenfuss III (at that time Senior Deputy Comptroller for Policy at the OCC) and study coordinators Steven J. Weiss and Judith A. Walter (Director and Deputy Director, respectively, of the OCC's Strategic Analysis Division). The Group of Thirty owes a debt of gratitude to them and to many others who have assisted in the work of the study group, notably toMr. Inigo Woolf and Charles Larkum of Midland Bank and Mr. John Henderson of Schroders.

The present report, which gives the results of the study group's deliberations, should be read in conjunction with the results of a comprehensive survey of banks conducted by the Office of the Group of Thirty on behalf of the study group, published under the title "How Bankers See the World Financial Market".

The following report focusses on three areas:

(1) country risk and the rescheduling of sovereign debt
(2) maturity transformation and the interbank market
(3) the handling of distressed banks

The study group believes that these areas merit special attention because they cover the range of issues that are raised (or could be raised) at an international level by the expansion of international lending and growing financial integration. Other areas, such as the risks in foreign exchange trading, while more complicated and perhaps less tractable as a result of the internationalization of banking, are nevertheless more endogenous to individual bank policy and thus more readily controllable by national supervisors.

In what follows, the discussion of each topic has been cast in a uniform format to the extent possible. Background information of a factual nature is set forth briefly in the opening paragraphs of the individual subsections. Next, concerns that have been expressed relative to a given topic are summarized. Evaluation of the concerns draws on secondary sources, the collective experience of the study group, and the above mentioned survey of 111 commercial bankers entitled "How Bankers See the World Financial Market".

Robert Pringle
Executive Director
Group of Thirty

May, 1982

Disclaimer

This report was drafted by the International Banking Study Group of the Group of Thirty. Some of those who participated in meetings of the study group hold official positions and attended as observers. They cannot for obvious reasons be held responsible for the views expressed in the report. Indeed, all the members of the study group attended its meetings in a personal capacity and policy recommendations cannot in any respect be taken to represent the views of institutions with which members are associated.

Risks in International Bank Lending

1. COUNTRY RISK

The large increase in international bank lending since 1973-74 has been accompanied by significant changes in the nature as well as the relative magnitudes of such activity from the standpoints of both borrowers and lenders. One of the distinguishing characteristics of many international loans during this period has been their purpose — the funding of current account deficits. Countries have resorted to overseas borrowing on an unprecedented scale to cushion the impact of adverse changes in their external circumstances — notably spiraling energy costs — and to finance industrialization and economic development programs. The result, for a number of borrowers, particularly some LDCs, has been a rapid increase in debt burdens, aggravated by high interest rates. For example, the ratio of debt service to export earnings for ten major LDC exporters of manufactured goods is estimated to have jumped from 13 per cent to 21 per cent between 1974 and 1981[1]. The outstanding debt owed to banks by four groups of major borrowers — smaller European countries, OPEC, Eastern Europe and non-oil LDCs totalled nearly $400 billion at the end of 1980.[2]

Moreover, whereas balance-of-payments financing needs were formerly viewed as short-term, cyclical, liquidity problems, current payments imbalances are often structural in nature. As a result, many borrowing countries now face periods of basic structural readjustments. Thus, greater demands are being placed on domestic management capabilities of borrowing countries to devise and implement the necessary economic adjustment programs.

While borrowers' debt burdens have grown, so have the relative magnitudes of banks' international loans in loan portfolios. Recent U.S. data highlight the growing importance of LDC borrowers: the aggregate exposure of the nine largest U.S. banks to LDCs has increased from 1½ times total capital in 1977 to more than double capital in 1980, and by the end of 1980 there were 80 instances of U.S. banks with exposure to single LDCs greater than 30 percent of capital funds. More generally, foreign assets and liabilities now account for a large proportion of total assets and liabilities of the banking systems of many OECD countires: for the OECD as a whole, the ratio nearly doubled during the 1970s, from 12 per cent to about 22 per cent.

---

[1] IMF: *World Economic Outlook*, June 1981, p. 135.

[2] BIS Annual Report, 1981, p. 105.

Risks and Concerns

The extension of credit across national borders in non-local currencies complicates the traditional assessment of a borrower's ability to repay because "country risk" is a factor. Under the rubric of "country risk," most analysts distinguish "transfer risk" from "political risk".[3] "Transfer risk" is the danger that a country may impose restrictions on remittances of capital, dividends or interest payments to foreign investors as part of its economic policy. In addition, repayment may be endangered by political developments, like civil or local wars.

Recently, concern about country risk has increased. There is a general belief that, at the same time as more and more banks are involved in international lending and the relative magnitude of the international portions of loan portfolios has been growing, the actual risk inherent in such activity has grown. At the same time, there is skepticism about the efficacy of approaches that banks have taken to country risk assessment.

The concerns suggest two lines of inquiry:

1) Have the risks of international lending increased? If so, how?
2) How are banks managing those risks? What is the supervisor's role?

---

[3] A few definitions of terms may be useful to the reader:

Country risk is taken to refer to the possibility that sovereign borrowers of a particular country may be unable or unwilling, and other borrowers unable, to fulfill their foreign obligations for reasons beyond the usual risks which arise in relation to all lending.

Country risk assessment, following on from the above, refers to the methods used (by lending banks in particular) to evaluate the risk of an interruption in the servicing or repayment of obligations by borrowers of a particular country.

Country exposure is taken to refer to an individual bank's or banking group's exposure in its total claims on borrowers in individual foreign countries. Measures of exposure to a particular country may take account of guarantees or other factors that could shift risk to a different country from that of the borrower.

Country indebtedness is taken to refer, in an international context, to the sum total of external borrowing by a particular country from all sources.

Sovereign risk arises from the special risk associated with a sovereign loan, which is a loan to, or guaranteed by, a government (and some government-guaranteed bodies). The special significance of such lending lies in the risk that it might prove impossible to secure redress through legal action i.e. the borrower might claim immunity from process or might not abide by a judgment.

The second area, that of risk management practices, in turn raises a series of subsidiary questions:

- What techniques of risk management and/or reduction are employed?
- Is country risk assessment effective? What are its flaws?
- Are some banks better positioned than others to assess country risk?

Gauging the Overall Risks

The most frequently used indicator of the risk of bank lending activity is the loan loss record which can be used to assess risks in relation to particular categories of lending. Across-the-board data for major international banks engaged in international lending are not available, but the loan loss statistics for the largest U.S. banks may be representative. By this measure, the record appears to be reassuring since loan losses have been far lower for international than for domestic activities. Moreover, the loss record has been improving. For the ten largest U.S. banks, international net loan losses as a percent of average international loans dropped from a record 0.39 per cent in 1976 to 0.10 per cent in 1980. International net loan losses relative to total losses have also dropped, from a peak of 29.3 per cent in 1977 to 15.3 per cent in 1980. However, such statistics do not reflect the less direct costs of reschedulings to banks. Although most banks say those indirect costs in management time, liquidity, income and portfolio quality have not been high to date, many believe those costs may grow.

The views expressed in the accompanying banking survey[4] on future riskiness of international bank lending were mixed: 40 per cent of respondents expected a 'substantial increase' in the riskiness of international lending over the next five years to the end of 1986, but a majority expected 'no significant change' or a 'modest increase'. A large number of reschedulings involving large sums or a default by a major country borrower were seen as the most serious threats to the system.

How Banks Assess Country Risk and Manage Exposures

Existing systems for assessing country risk vary in approach and complexity from bank to bank. The study group's bank survey confirmed that nearly all banks have increased the resources dedicated to country risk analysis (it also confirmed that smaller banks rely more than larger ones on country risk assessments by others, such as syndicate leaders and correspondent banks).[5] However, there are acknowledged problems with both the economic and the political sides of country risk assessment systems.

---

[4] "How Bankers See the World Financial Market", Group of Thirty, May 1982.

[5] Appendix I summarizes nine systems which have been used or are in use at some major U.S., Canadian, and European banks.

The more serious problems on the economic side stem from the deficiencies of the data. True, the quality of data has improved somewhat in recent years, and additional efforts at improvement are currently under way. (For example the IMF and BIS have recently been discussing efforts to expand and improve banking information.) Nevertheless, there remain some significant deficiencies in both the quality and availability of the data.[6]

Lags in data reporting can be quite serious, sometimes rendering the available statistics virtually useless. There is much evidence that many banks simply did not know the magnitude of the debts of either Turkey or Poland, before the crises in those countries erupted.

Even assuming reliable and current economic data, however, there are still differences of opinion regarding how well banks use and interpret the data. There are past instances, for example, of banks' enthusiasm for lending being based on a country's natural resource endowments without a concomitant realistic appraisal of the country's ability to *manage* its natural resources. Currently, most country risk analysis systems utilize a number of economic indicators to develop measures that serve as indicators of country risk. While the ratio of debt service to exports is widely acknowledged as an important measure, opinions differ as to the significance of a number of other measures often used to predict the ability to service debt.

Recently, banks have placed increased emphasis on assessing political and social factors in borrowing countries. A number of banks have hired political experts and incorporated political considerations in their analysis in new ways, including attempts to develop lists of socio-political "early warning indicators." However, such judgments are no doubt even more problematical than economic analysis. Despite new attempts to take political factors into account, such analysis has often failed to detect important trends, such as political developments which, for example, in the case of Poland, may have contributed to the need to reschedule.

In the end, of course, even very sophisticated country risk assessments may be overridden by other considerations. Final action may run the range from voluntary decisions, based for example on perceptions of marketing opportunities, to those that are less than fully voluntary. Examples in the latter category would include situations where the bank is afraid of jeopardizing a large existing exposure if it withholds new loans or instances of strong external pressure from the bank's home government arising from foreign policy motivations: one quarter of banks responding to our survey believed that lending had been significantly affected by such pressures. Also, since a bank's competitive status depends importantly on the regard of others in the system, some banks may feel pressured by the desirability of cooperating with other lenders. Finally, some banks may act, at least in part, out of a sense of responsibility to help maintain the longer-run stability of international lending markets.

---

[6] Country debt service data, for instance, do not capture all annual amortization requirements; military debt, which is often large, is usually excluded from official statistics; and statistics on short-term debt (up to one year) are frequently deficient.

Competitive pressures may lead banks to override country risk assessments and engage in imprudent lending. Particularly in the early stages of country lending, competitive behavior tends to dominate. This can mean that new money will continue to pour into a country once it is "in vogue," even though signs of economic difficulty may already be evident. For instance, in the cases of Peru, Turkey and Poland, even when banks were beginning to feel more cautious about further lending, those countries were able to sustain the inflow of funds. In such ways, a country can accumulate excessive debt.

Debates about the efficacy and actual use of country risk assessment systems notwithstanding, banks can and do protect themselves from undue risk concentrations in a number of ways. For example, there are means by which banks reduce or spread the risks of involvement with a particular lender. These include syndication of large loans, co-financing with multilateral institutions, insuring loans with either private or public agencies, or securing home government guarantees through national export banks or agencies.

Most importantly, banks typically follow policies and practices promoting loan portfolio diversification as the main method of managing international risk exposure. Nearly all banks set lending limits to individual countries, sometimes as a proportion of capital and reserves or of external or total assets. To arrive at limits, subjective judgments (whether derived from elaborate country risk analyses or not) are translated into objective ceilings. Most banks can follow strategies that allow them to allocate, measure, and monitor quite closely their country risk exposures.

Supervisory Practices

Supervisory practices also play a part in the management of country risk. In general, the principal role of the supervisory authorities is to help the individual bank carry out the task of country risk assessment on its own responsibility and to satisfy themselves about the ways in which the bank evaluates country risk and monitors its own exposure to each country. It is not entirely clear how and to what degree various national regulatory authorities currently fulfill this role. However, bank supervisory evaluation of bank's country risk systems does appear to be becoming more widespread. Also, supervisors follow more closely than formerly trends and concentrations of risk in their banking systems, and/or at individual banks, by collecting statistical reports on country exposure. In the U.S., because of the nature and history of bank supervision, supervisory authorities make an independent judgment regarding the risk in lending to particular countries.

The practice is not much in evidence elsewhere; but many countries apply requirements designed to prevent undue risk concentrations. (A description of supervisory systems in a number of G-10 countries is at present being prepared by Richard Dale of the Brookings Institution, to be published later this year as part of the overall work of The Group of Thirty. Meanwhile, a brief overview of relevant national regulatory arrangements is supplied in Appendix D).

Conclusions

There have been no major disasters for the international banking system arising from the growth in international lending activities. However, our survey confirms that most bankers believe that risks have increased and will increase more rapidly in the future. Evaluating the degree to which this may be true is of course no simple matter. For instance, there are factors which appear to mitigate the relative burden of debt for some borrowers. These include growing GDPs, higher levels of reserves, and above all improvements in economic policy-making in most debtor countries enhancing their own ability to adjust to changes in external circumstances. Yet the rapid growth and relatively high level of international indebtedness has certainly increased borrowers' vulnerability to exogenous events which could impair their ability to service debt. At the same time, the growth in the ratio of international to domestic assets in bank portfolios suggests that the system's vulnerability to 'shocks' may also have increased.

The concerns generated by aggregate figures on debtor condition and country exposure are often exaggerated. A variety of official support functions are already in place. To the extent that ultimate country lending risks are borne by government or multilateral institutions which lend directly, co-finance with banks, subsidize, insure or guarantee bank loans, the actual risk of commercial banks is at least partly underwritten.

More significantly, borrowers represent a range of risks, and banks manage their exposures with the intention of avoiding undue concentrations of risk. Especially in the last several years, banks and their supervisors have devoted considerable effort to improving management of international loan portfolios. The question remains as to whether these efforts are fully adequate at a time when the system has probably become more vulnerable to shocks — and perhaps more likely to experience them. Weighing these partly conflicting considerations, the study group believes the following observations are relevant:

1) Banks' decision-making sometimes appears to take place against a background of insufficient factual information. This is partly because

there remain serious inadequacies in the data upon which country risk assessments are based. International debt data for short-term borrowing are particularly deficient. Further efforts should be made to improve the quality, timeliness and availability of the basic economic data available to lenders.

2) To this end, means for centralizing data collection could be explored. Many members of the study group believe that some degree of centralization of data analysis would be also be appropriate. Judgments and decisions, however, should be left to individual banks.

3) Risk assessments may be influenced by other considerations. There is evidence that competition for business within the international banking market has sometimes resulted in excessive debt accumulation by borrowers, leading subsequently to debt servicing problems.

4) The study group believes that bank supervisory authorities should be concerned with reviewing country risk management systems. However, it is not yet possible to reach firm conclusions about the effectiveness of such reviews. It is also the opinion of the study group that, as a general principle, supervisors should leave the task of actually making country risk assessments to the banks (while recognizing the special circumstances of U.S. supervisors, who are required by law and practice to make loan quality judgments).

2. RESCHEDULING

The number and magnitudes of country debt rescheduling have increased considerably in the last six years. Since 1956, there have been 53 official debt reschedulings involving 20 countries. Twenty-two of these involving 13 countries have occurred since 1975. In the recent past, banks have been a party in renegotiations with seven countries — Turkey, Zaire, Peru, Nicaragua, Sudan, Jamaica, Poland. Discussions are currently under way with Rumania, Costa Rica, Senegal and Liberia. The amounts involved in these reschedulings have varied greatly: $518 million for Peru in 1978, $421 million for Sudan and $1.3 billion for Zaire in 1979, $580 million for Nicaragua and $3 billion for Turkey in 1980. Rescheduling of Poland's debt repayments of capital due in 1981 alone involved $2.2. billion. (Poland's aggregate debt owed to banks outside Comecon, at about $17 billion, is a different order of magnitude from that of any other country previously involved in rescheduling).[7] Most of the banks' exposure to loans subject to rescheduling so far, however, have been relatively small in relation to their capital or earnings.

Concerns

The possibility of a substantially larger rescheduling, or a series of them, involving large numbers of banks, has created concern whether processes presently used will be adequate for the debt rescheduling of the 1980s. First, the rescheduling process is not codified and involves large numbers of participants — official creditors, banks and other private lenders, multilateral institutions, the borrower, and sometimes, investment bankers who are advisors to the borrowers. Second, increasingly serious consequences may arise from the conflict between creditors' responses and debtors' needs.

Again, the result of the G-30 survey are pertinent to these issues. Asked whether existing *ad hoc* arrangements would be adequate to deal with more frequent reschedulings involving larger amounts than in the past, 17 per cent said no, 54 per cent were uncertain, and 29 per cent said yes (i.e., were content with existing arrangements).

The concerns point to two sets of questions:

1) What are the arrangements usually adopted for rescheduling, their strengths, weaknesses, and risks?
2) What have the terms of rescheduling been? What have the consequences been for lenders and borrowers?

The Rescheduling Process

The rescheduling of official debt is handled by the Paris Club, an *ad hoc* group of western official creditors which, since 1956, has met informally when needed under the chairmanship of the French Treasury. Although there are no formal rules, the Paris Club has over the years adopted a set of unwritten procedures. The common practice is that the request for a meeting is initiated by the debtor country; generally the creditors have agreed to convene only after payments arrears have already occurred; and an agreement is concluded after the borrower has agreed to an IMF stabilization program. Since the only debt eligible for consideration is government obligations, the practice has been to include as participants at the meetings only the borrower and the principal OECD government creditors. Observers may include other government creditors, the IMF, World Bank, the OECD and UNCTAD. The unwritten rules extend also to the amount eligible for rescheduling (about 80 per cent of consolidated official debt over a 2-3 year period) and the repayment terms.

---

[7] Under an agreement signed in April, 1982, repayments of the $2.2 billion in capital that fell due in 1981 is to start in December 1985 and end in December 1988, with the interest rate for the sum rescheduled set at 1.75 per cent over LIBOR.

Because of the changing composition of developing country debt, banks have increasingly become involved in the rescheduling process. Hence troubled country borrowers may have to seek relief from the Paris Club or private banks or both.

There is no standard mechanism for rescheduling debt to private creditors; each case has required than an entirely new process be stated. The numbers of bank creditors involved in recent reschedulings and their nationalities have been large and growing — 115 banks from 12 countries in the case of Nicaragua, over 200 creditors for Turkey, and 500 for Poland. A small number of lead banks, usually a dozen of fewer, have formed a steering committee that actually participates in discussions. The members of the group may be selected by the borrower or the major creditors or jointly.

Bank reschedulings have been costly and time-consuming. Arrangements have taken from 6 months to 4 years to complete. Participants in the numerous loan syndications have had to be contacted; sometimes primary collection of basic data on outstanding loans has been necessary. A number of times the negotiations have had to be coordinated with parallel Paris Club rescheduling discussions. Procedural quarrels have sometimes added to delay.

Even though banks begin to "close ranks" once a rescheduling appears imminent, there is still a tendency for individual banks or groups of banks to pull in different directions. Thus it has been difficult at times to get agreement on coherent strategy. A 1976 bankers' attempt to obviate rescheduling by extending a balance-of-payments loan to Peru, for example, was undercut when some other banks simultaneously reduced their short-term credit lines to Peru. Divisions among banks during a time of crisis tend to be along national lines. The divergence may have any number of roots, including relative levels of exposure to a particular country, political pressures from home governments, or different accounting practices and/or capital requirements.

In most reschedulings the IMF plays a critical part in devising and imposing needed economic adjustment programs. As mentioned earlier, since 1966 the Paris Club has refused to proceed with reschedulings until the borrower has agreed to an IMF adjustment program. Banks, too, have sometimes made their rescheduling contingent on the borrower's acceptance of IMF conditions. In the case of Peru, banks discovered that they alone did not have the sanctions to impose conditions for economic adjustment.

Poland's application to rejoin the IMF aroused expectations that such a move would facilitate the rescheduling of Poland's 1982 debt repayment.

The IMF can play a useful role as a catalyst exerting pressure on both sides to move towards a settlement. Indeed, in the Nicaragua rescheduling, where the IMF was not itself involved, other multilateral institutions such as the InterAmerican Development Bank , World Bank, and Central American Bank for Economic Integration played a somewhat analogous role.

Rescheduling Terms

With few exceptions, rescheduling whether by Paris Club or private creditors has consisted of a lengthening of maturities of principal repayments at market rates of interest. Banks have been particularly insistent on maintaining commercial terms and (except in the case of Nicaragua) have thus far upheld the principle that interest payments may not be rescheduled. Although borrowers have negotiated for lower spreads and fees, they have tended to accept lenders' determinations of grace periods and final maturities. For Paris Club debt the average maturity has lengthened only from 8 to 10 years since 1975. Bankers have rescheduled on similar terms with average terms of 7 to 10 years with up to 3 years grace at rates of LIBOR plus 1¾ to 2 per cent.

Creditors have so far emerged relatively undamanged from rescheduling. Paris Club creditors have undertaken no concessional debt restructurings since 1971. In a present value comparison of official loans before and after the debt rescheduling over the period 1956-1980, Chandra Hardy estimated the loss to creditors at only about $2 billion or 0.5 percent of the total debt outstanding and noted that "since 1975, there has been no loss to the (Paris Club) creditors."[8] Although it is not possible to duplicate these calculations for bank debt, estimates indicate that private creditors have probably not suffered a financial loss on a present value basis either. From the borrowers' perspective, however, the terms have been quite onerous, failing to reflect their likely cash flows and essential adjustment plans. Short maturities and creditors' insistence on rescheduling only one year's debt at a time have increased the likelihood of subsequent liquidity problems and the necessity for a subsequent rescheduling.

Conclusions

Most members of the study group believe that the present *ad hoc* mechanism may be insufficient for the needs of the 1980s. They emphasize that future reschedulings are likely to be larger, more numerous and more complex, increasing the risks that the present system will prove inadequate, partly by creating intolerable delays. Most, then, see a need for banks collectively to be better organized to handle their role in rescheduling more effectively.

---

[8] Chandra Hardy: "Rescheduling Developing-Country Debts, 1956-80; Lessons and Recommendations" Overseas Development Council Working Paper, No. 1.

There also appears to be a need for re-thinking the principles on which rescheduling terms are struck. It is nearly always true, of course, that opinions about optimum terms for debt repayment will differ among negotiators. In some cases, the outcome appears thus far to have been reasonably satisfactory — the experience of Turkey and Jamaica may be cited. However, in some cases of sovereign debt reschedulings it has been argued that the terms have been based on an excessively narrow or short term view by the banks on their own best interest. On this argument, by focusing solely on the criterion of reaching an agreement on market terms, creditors may either have failed to recognize or turned a blind eye to economic and political realities confronting the borrowers. The result sometimes has been to set in place conditions likely to result in more problems later — an eventuality that is in the best interest of neither the banks nor the borrower.

There are precedents for less rigid approaches to debt restructuring in bank relationships with corporate borrowers. Given increasing recognition that the balance-of-payments problems of many borrowing countries stem from long-term structural development needs, the challenge for future reschedulings will be to reach terms that strike a better balance between the medium-term interest of banks and the timescale over which borrowers realistically are able to resume full debt service. While putting this forward as an ideal the study group is nevertheless aware of the practical difficulties of achieving an optimum arrangement. Banks in international syndicates are subject to different national taxes and national regulatory laws and supervision. "Equal" treatment for a borrower in an international rescheduling could mean unequal treatment for lenders. The essential point is that all interested parties should get together at an early stage in a country's debt-servicing difficulties. The study group feels that the IMF should usually play the leading role in gaining acceptance by all parties to the key elements in a stabilization program. However, in the group's judgment, there is also a strong case for considering the establishment of a representative body for the banking industry to help improve the flow of information available to lenders, discuss issues related to debt servicing difficulties and develop expertise in this area that would be of assistance to both borrowers and lenders (see chapter 7).

3. INTERNATIONAL INTERBANK MARKET

The international interbank market links banks to one another much as domestic money markets link banks within national markets. The market owes its existence to the need of banks to be able to bid for funds of a particular maturity to fund a loan of a similar maturity and their need to lay off unwanted deposits with other banks. Funds are thus shifted within the international banking system — and between the international market and domestic markets — as banks take deposits from and/or place deposits with one another. The market serves an important intermediary function between savers and borrowers on a global basis. By reallocating funds in the same currency among banks, it also permits participants to generate and/or manage liquidity.

Initially limited to transactions among major multinational banks, the market has grown from a few hundred banks in the mid-1970s to well about 1,000 banks from more than 50 countries by 1981.

According to BIS estimates, the size of the market grew from about $182 billion in 1975 to $522 billion in June, 1981. The world's largest banks play a predominant role in the international interbank market. The banks to which they lend typically relend a certain proportion as well. Most banks participate actively on both sides of the market. Reliance on interbank funding tends to be higher for smaller banks and newcomers in the international market, banks without a U.S. dollar base, and consortium banks. The market constitutes an indispensable source of funds for many banks' international activity; a recent study suggests that interbank deposits account for between two thirds and three-quarters of total external and Eurocurrency deposits.[9]

Two features deserve special mention — the practice of redepositing and the classification of banks according to perceived riskiness ("tiering"). It is not uncommon for funds from nonbank depositors to pass through a chain of interbank transactions before finding an ultimate borrower outside the banking system. Active trading on both sides of the market may accomplish one or more of the following purposes: (1) keeping the bank's name in the market; (2) enhancing the size of bank by increasing total footings; (3) establishing reciprocal relationships that will assure access to liquidity, or access at a reasonable price, in event of a squeeze (banks that only take funds are said to fare especially poorly when markets are tight); (4) gathering current market intelligence about both changing conditions of supply and demand in the market and the market's sense of the needs and conditions of individual participants. The bank survey shows that most banks re-deposit more than 40 per cent (nearly 60 per cent in the case of the largest banks) of interbank deposits.

---

[9] J.G. Ellis, "Eurobanks and the Interbank Market" *Bank of England Quarterly Bulletin*, September 1981.

The perceived risks of placing deposits with particular banks have been reflected in pricing tiers and/or credit limits. The number of tiers and differences in rate between them tend to increase in times of market uncertainty. The Herstatt collapse of 1974, though originating in overtrading in the foreign exchange market, appears to have provoked an extreme instance of pricing tiers; some banks paid as much as 2% above LIBOR. However, the pattern of interbank rates returned to normal within a few months.

In current practice, differentiation among banks in terms of credit lines may be more significant than the minimal tiering in deposit rates. As the study group's survey confirms, banks in the market typically establish daily and overall limits for the funds they will place with (loan to) other banks. These are usually not disclosed, committed lines but are internally imposed limits set by credit officers as parameters for bank traders.

Risks and Concerns

There are two levels of risk associated with the market — risk for individual banks based on their particular characteristics and market activity and risk for the system as a whole. First, since banks participate on both sides of the market, they are confronted with both credit and funding risks. Second, and more importantly, there is an underlying concern that because of the interbank linkages even sound banks might not be immune from a problem caused elsewhere in the system because of the knock-on effect. In the case of the UK fringe banking crisis of 1974, even perfectly sound banks suffered.

The above-mentioned survey by the Group of Thirty showed that a majority of banks feel that interbank activity may be becoming more risky because of a change in the composition of the market (an increasing proportion of interbank borrowing being done by second and third tier banks). And bankers rated "unavailability of interbank funds" as great a potential threat to individual banks, though not to the system, as "default by a major country debtor."

The concerns that have been articulated in the press and elsewhere can be summarized as follows:

- How have banks and bank supervisors responded to the funding risks in the market?
- Has risk in international banking increased because of growth in the interbank market? Do the inherent characteristics of the market contribute to its instability or stability?

Banking Practices

In the past, banks were "often prepared to lend on an interbank basis with relatively little financial analysis or personal knowledge of the borrowing bank . . . on the implicit assumption that a participant in the market possessed sufficient capital resources, support from stockholders (or parent bank) or a potential call on central bank assistance to be able to meet its obligations."[10] In the aftermath of the international banking crisis of 1974, banks began to review this assumption, tightening and improving their credit analysis practices, utilizing stricter limits and controls, and developing more direct personal contacts.

Many banks now treat deposit placement lines in the same way as credit lines, basing overall limits and individual transaction limits on assessments of creditworthiness, including consideration of country risk (99 per cent of respondents to the G-30 survey said that country risk played a significant role in determining interbank placement and credits).

Four factors may influence decisions. First, *financial statements* may be analyzed. Some banks do a careful analysis of even the largest banks, supplemented by visits by bank staff. Banks without the resources to collect and compile financial information themselves can purchase balance sheet and income statement data along with some standard ratios from several outside sources.

There are problems, however, in interpreting annual reports because accounting conventions and disclosure practices vary widely. For this and other reasons, banks themselves as well as some of the new credit information services, place a great deal of emphasis on a second set of factors. These are the *ownership* of a bank (and the nature of its relationship to its parent institution, if there is one) and the bank's *national support systems* — the quality and degree of bank supervision and consideration of lender of last resort facilities; 69 per cent of respondents to the G-30 questionnaire said that they evaluated the willingness of the other bank's government or central bank to come to its aid in adversity. Third, banks watch for *unprofessional* money market dealings and evidence of overtrading. (This, too has its limits since skillful liability management can hide problems, although for only a short time). Finally, banks, to varying degrees, strive for a qualitative *assessment of management*.

However, not all banks exercise the same degree of care. Some banks omit or do only a cursory analysis of the very largest banks; some apply general rules of thumb, e.g., considering the largest banks in the world or in any country to be unquestionably creditworthy; and others appear to rely heavily on the judgment of their correspondents. The G-30 survey provides some evidence to support the contention that some banks act on the faith that all the banks with which they place deposits are well regulated and will be backed up by their central banks, even outside the Group of Ten countries.

---

[10] Steven I. Davis, *The Euro-Bank* (John Wiley & Sons, 1980), p. 76.

Although many banks assure the availability of standby lines (paying commitment fees for these when necessary), interbank lines are not always assured, and may indeed dry up for any individual bank when most needed. Many banks therefore take great care to maintain and test lines and cultivate overall relationships with other banks. Diversification of sources is clearly important. Banks employ various techniques to monitor their lines and try to gauge as well as possible how much they can tap from different sources and in different currencies and maturities. Additional business relationships may be developed to reciprocate for lines, and personal contacts may be deliberately cultivated as well.

Supervisory Practices

As with banking practices, it is difficult to make generalizations about supervision of banks with respect to their activity in the interbank market. Beyond qualitative supervision of bank practices, the capital adequacy and liquidity requirements or guidelines of bank supervisors would play a role in placing outside bounds on the aggregate level of a bank's interbank liabilities. (See Appendix D). About one third of banks responding to our survey reported that their home supervisory authority does not monitor their bank's international interbank lending and deposit placement activity.

Support Mechanisms and System Stability

The market as a whole has so far been resilient in the face of external shocks, as was demonstrated by the moderate reaction to the Iranian asset freeze. This may be partly because the breadth and depth of the international interbank market tend to limit the damage when funds are switched in response to a shock, because that causes no net loss of liquidity to the system. As a result, there is a greater chance for a reflow of funds (with adjusted rate differentials) as long as there is no generalized loss of confidence.

However, it is always important to prevent the spread of contagious mistrust. In the case of serious shock, smooth functioning of the market rests critically on a rapid restoration of confidence and may therefore, depend also on the assurance of adequate support mechanisms. The market's ultimate dependence on official support mechanisms is heightened by the nature of market relationshps. Since deposit lines are discretionary, some degree of credit rationing appears likely in a general crisis. To the extent that this occurs, banks faced with a sudden unavailability of funds and unable to obtain new funds by raising rates would be at least temporarily reliant on official support.

There are various forms official support may take — including lender of last resort and other, *ad hoc* arrangements. For the interbank market, the somewhat paradoxical role of these mechanisms in their dormant state, i.e., short of actually being called into action, is to maintain a degree of ambiguity as to when and under what circumstances an individual bank will be given support while at the same time sustaining confidence that shocks to the system will be controlled and neutralized. The ambiguity serves on the one hand to induce discipline on the part of market participants while at the same time fostering confidence sufficient to ensure that shocks will not trigger panic. Hundreds of new participants have entered the interbank market in recent years, many of them relatively small. The quality of supervision of a number of such banks from outside the major countries and uncertainty about access they might have to lender of last resort facilities in time of crisis leaves cause for concern.

Conclusions

The interbank market has functioned remarkably well; its considerable breadth, liquidity, and efficiency enable the international banking system to accomplish its enormous recycling task smoothly. The major change in the market is the proliferation in participants that has introduced second- and third-tier banks and banks from a number of non-GIO countries to the system. This bears on both the risks facing individual banks and the system risk and is the main reason why banks themselves feel that the riskiness of the market has increased.

It appears from the survey results that banking practices have changed in response, although the extent to which this is true is difficult to gauge. The treatment of bank deposit facilities as credit lines is a positive development; it is just as important for banks to perform careful credit analysis when lending to other banks as when lending to non-bank borrowers. Similarly, effective monitoring and management of funding risks are highly desirable.

For large, well known banks, taking interbank deposits may not present funding risks significantly different from other types of interest-sensitive, short-term liquid liabilities. However, smaller banks, newcomers, and banks without an established funding base are more vulnerable than the major multinational banks to increased tiering of rates or unavailability of funds in the event of a loss of confidence. The possibility of a re-emergence of steeper tiering or withdrawal of standby lines under adverse market conditions, which would naturally have a particularly marked effect on banks that are large 'net takers' of interbank funds, should add an element of self-discipline for all participants. Because of such considerations, and the lack of 'transparency' of the market — the difficulty in ascertaining the ultimate sources and uses of funds — reliance on the inter-bank market bank placements as a source of effective liquidity may be less than it appears to be.

It would seem appropriate for smaller banks and new entrants to the market to exercise special care and take a relatively more cautious approach to interbank funding, but it is not clear that all of them do so. The increase in activity in Euro-market brokers may reflect a relative increase in overall deposit-taking and placing by less well established banks, and funding obtained through brokers may be less reliable in times of difficulty because it does not carry with it the backing of business and personal relationships which many banks have cultivated.

It is worth emphasising that a bank is not necessarily a better or worse risk than any other type of borrower even though it is increasingly the case that supervisory authorities in each country pay special attention to the continued stability of such institutions. Decisions to extend credit facilities to, or place deposits with, a bank must therefore be made on an assessment of the quality of management and fundamental strength of the bank concerned, the economic and political condition of the country in which it resides and a judgment of the quality of supervision in that country. The willingness and ability to its central bank to provide "lender-of last resort" support in an emergency should not be taken for granted.

4. MATURITY TRANSFORMATION

While the practice of maturity transformation, namely receiving deposits at one maturity and lending at another, is an integral part of financial inter mediation, perceived changes in Euromarket conditions and practices have prompted renewed attention to the subject. On the asset side, a borrowers' market has at times produced a lengthening of maturities. On the liability side, typical OPEC preferences for short-term deposits have been reinforced by rising short-term interest rates which have induced other depositors as well to seek shorter terms.

Competition in loan markets has at times resulted not only in a lengthening of lending maturities, but also a shrinkage of loan margins, putting pressure for extra income on other bank activities. At about the same time, a shift in the U.S. approach to monetary policy, emphasizing management of monetary aggregates vs. short-term interest rates, was accompanied by great volatility of U.S. rates and hence Euromarket rates, making portfolio management more difficult. In 1980 and early 1981, substantial losses on mismatched positions were reported by a number of major multinational banks. Others, however, profited from the new volatility of interest rates. This greater volatility increases both the risks and possible rewards of mismatching.

It is important to try to distinguish the two components of risk in maturity mismatching — interest rate risk and funding (liquidity) risk — and to understand how Euromarket practices affect each. The interest rate risk component is to a great extent alleviated (but not eliminated) by floating rates and the rollover technique which pass interest rate risk on to the borrower. The effect in a period of rising interest rates is to increase credit risk. The extent to which a bank covers itself against interest rate risk depends for the most part on how closely it matches liability maturities to the rollover maturities in its assets. If a loan that is repriced every six months is funded with 30-day money, the bank's exposure to potentially adverse changes in market rates of interest is not fully covered. In addition, smaller, less well-known banks would continue to be vulnerable to increased tiering of rates even if liabilities were completely matched to asset rollover dates.

The rollover mechanism does not, however, neutralize funding risk — that is, the possibility that a bank may be unable to tap resources to meet its continuing obligations. For the market as a whole, supply and demand are kept in balance by interest rates; however, the market response for particular banks in different circumstances can vary considerably. Banks with established names can reasonably expect to tap even a large amount of funds, when needed, and at relatively advantageous rates. For smaller, less well known banks, particularly relative newcomers or ones without a connection to the U.S. dollar market, the funding risk may be a real one.

Bank Practices

In the 1970's many banks began to re-examine procedures for asset and liability management with an eye to greater global coordination. Most banks monitor their liquidity positions with some care. As in the case of foreign exchange positions, top management sets general policy for maturity mismatches and puts limits on discretionary decisions by lower managers, based on assumptions about movements in rates. The range of practical approaches to fund management runs from centralized global control to decentralized, local (profit center) control. Neither way is clearly superior; there are advantages and disadvantages to both. Banks' actual practices vary. About 40 per cent of banks participating in the G-30 survey indicated that they had reduced limits in reaction to greater risks posed by the current volatility of interest rates.

Supervisory Practices

Bank supervisors are aware of special problems in liquidity management that may arise from banks' international operations. But direct comparison of the approaches adopted by different supervisors is rendered very difficult by the variety of techniques used to measure "transformation" and wide institutional differences. It may be noted, that about one third of banks participating in the survey said that supervisors' performance in monitoring their mismatched positions was "poor" or "fair".

Because of the inadequacy of existing statistics, the Committee on Banking Supervision and Regulatory Practices under the chairmanship of Mr. Peter Cooke has been working to try to encourage and develop a uniform reporting system to be used by the BIS to collect data on banks' maturity mismatching, particularly with regard to their international business.

A number of supervisors (e.g., France, Japan) have increasingly urged their banks to fund a proportion of their long-term foreign currency assets with long-term foreign currency liabilities, partly at least because in foreign currency business, banks have no automatic lender of last resort to turn to who is itself the issuer of the currency in question.

Conclusions

Available maturity structure data make it impossible to reach any conclusions about whether the degree of mismatch has worsened. Efforts by bank supervisors to improve the collection of statistics of this kind are thus a positive development and for these statistics to be fully meaningful it is important that the coverage of data should embrace international banks' worldwide business.

Yet even if no worsening of trends on a consolidated basis has taken place most bankers and study group members believe that interest-rate volatility has tended to increase riskiness of traditional mismatch practices. This increased risk requires banks to be more cautious. Furthermore, of course, losses themselves will tend to have the healthy effect of inducing greater discipline in bank practices. Whilst banks' managements are responsible for their own mismatching practices, supervisors must also be concerned to ensure that these are prudently established and operated.

5. DISTRESSED BANKS

The growth of the international banking system has increased the potential range of problems created by bank failure. The problems of a single bank, unless contained, could have an impact through the international interbank market; banks and banking systems are always vulnerable to confidence crises. Moreover, the transnational structure of the international banking system and the potential global spread of contagion have enormously complicated the management and resolution of bank failures and distressed bank situations.

Three different cases of bank failures in the last decade illustrate some of the international ramifications such occurrences may have, not only the unfolding distress of the bank itself, but also the nature, extent, and timing of crisis resolution by national banking authorities.

- In June 1974, the Bankhaus I.D. Herstatt, which had incurred large foreign exchange losses, was abruptly closed by the German Federal Supervisory Authority for Credit Matters. The collapse of the bank shocked the markets, which had not previously demanded risk premia for interbank transactions. After the Herstatt crisis, rate tiering appeared, and many sound banks had difficulty getting access to funds simply on the ground of being small.

  In addition, by closing Herstatt at the end of the banking day in Cologne but just after the beginning of the banking day in New York where scores of Herstatt's foreign exchange contracts were in the midst of settlement, the German authorities inadvertently interrupted the international payments mechanism. Herstatt's principal New York clearing bank, Chase Manhattan, froze the account. Debit orders were not honored; credits coming in were not returned. A race for Herstatt's New York assets by its creditors from around the world ensued.
- At about the same time as Herstatt's problems were becoming more visible in the spring of 1974, U.S. banking authorities were in the midst of a protracted attempt to prevent the collapse of Franklin National Bank, then the 20th largest bank in the United States. A decision by the Federal Reserve Bank of New York to provide emergency liquidity assistance in substantial amounts had as one of its two main objectives prevention of "the severe deterioration of confidence, at home and abroad, that would have resulted from an early failure of the bank." (Federal Reserve Bank of New York, Annual Report, 1974.)

  The same concern for international market stability, which was shared by other central banks as well, also prompted the Federal Reserve to acquire Franklin's foreign exchange book when the market, fearing the bank would fail to perform on contracts, began to refuse to sell foreign exchange to Franklin.

  Because Franklin had a large London branch, management of the problem required the Bank of England's cooperation at two junctures. First, during the months of liquidity assistance, the steadily increasing need for collateral for Franklin's borrowings from the Federal Reserve required the use of assets at the London branch. Second, the ultimate solution, a purchase and assumption transaction, required that the Bank of England help to secure the necessary approvals under English law for transfer of Franklin's London assets to the FDIC which acted as receiver prior to the sale to European-American Bank.
- In the spring of 1980, Argentina's Central Bank ordered the liquidation of Banco Intercambio Regional (BIR), the country's second largest private bank. The exposure of foreign banks was about $80 million. Foreign

currency deposits were not covered by Argentina's deposit insurance plan. Moreover, Argentinian authorities, claiming lack of authority, refused to accept responsibility for claims on BIR's New York branch. The New York State Banking Department took possession of the branch, hoping to be able to pay off depositors and creditors by selling branch assets.

The liquidation of BIR triggered a run on deposits at other Argentinian banks. The Argentine Central Bank was forced to inject an estimated $2 billion to avoid a collapse of the private banking system. In the meantime, the country's $10 billion accumulation of foreign exchange reserves had begun to drain away, leading some concerned observers to worry about the adequacy of Argentina's resources to meet a potentially prolonged banking crisis.

Concerns

Concerns about distressed banks and their impact on the stability of international financial markets spring from perceptions of the large degree of interdependence among banks from all over the world and market doubts about the ability of existing lender-of-last-resort facilities to manage and contain future crises of potentially global proportions.

A majority of bankers participating in the G-30 survey expressed their agreement with the proposition that "the international banking system would be vulnerable to a chain collapse in the event of a crisis affecting a significant bank or group of banks", although supplementary comments suggested that they considered this eventuality to be improbable. More than two-thirds said, however, that there was "a need for clearer understanding of lender of last resort facilities."

Two distinct lines of questions are raised by such firm comments:

- Do individual national authorities have the capacity (powers, resources, judgment) and willingness to act to avert an international crisis?
- Given the complex transnational structure of the international banking system, is there sufficient clarity of responsibility, i.e., which central bank is responsible for which banking institution?

Crisis Management Mechanisms

The organization of nations' crisis management systems reflects different national legislation and policies. In the United States and a few other countries, rescue responsibilities are divided among the institutions that respond to illiquidity and those that deal with insolvency. The distinction, of course, is not easy to draw, and interaction of the two functions is sometimes required to meet emerging problems. In some countries, the central bank has responsibility for handling crises both of illiquidity and of insolvency, though this is by no means true of all. However, in some of the latter countries there are other institutions for dealing with insolvency.

Crisis management mechanisms may take a number of forms, including lender of last resort facilities, deposit insurance and *ad hoc* arrangements. Regardless of the original source or nature of an individual bank's problems, what triggers a crisis of confidence for the whole banking system is a liquidity crisis. In order to stave off or contain such a crisis, authorities must be able to provide needed liquidity quickly to avoid a panic run on deposits. Hence debates about dealing with distressed banks in an international context have tended to concentrate on lender of last resort facilities.

In the classic view, a lender of last resort is an institution which has the responsibility to provide the residual liquidity needs of the financial system rather than to specific institutions. These may arise in day-to-day activity or in emergency situations. In the latter case, the lender of last resort may prevent and neutralize the impact of financial shocks by lending to institutions during periods of crisis and by acknowledging its duty to lend in the future. In fact, the presence of a lender of last resort alone may be sufficient to sustain public confidence.

At the same time, the efficacy of lender of last resort and other kinds of support arrangements requires that they should not be viewed as providing an unconditional guarantee. Such a guarantee would have the perverse effect of encouraging some banks to take undue risks in the belief that if they got into trouble rescue by national authorities was assured.

The development of lender of last resort facilities and other types of crisis management mechanisms is closely related to the degree of maturity of a country's banking system. Such facilities are usually not questioned for the G-10 and other industrialized countries. However, as already noted, the increasing participation in the international system of banks from developing countries has given rise to some unease, in large part because the quality and commitment of their national support arrangements are not clear.

The transnational structure of the international banking system poses additional questions of access to lender of last resort facilities for several types of banking institutions. These include foreign subsidiaries and participations and sometimes even foreign branches which, in a crisis, may be unable to obtain access to their parents' lender of last resort. Increasing numbers of multinational consortium banks add their own element of uncertainty.

The Response of Banks After Herstatt

Since 1974, the behavior of banks in the interbank market has reflected varying perceptions of the support that may be made available to a distressed bank. Some banks treat possible unwillingness or inability of a central bank to support its national banks as part of country risk and may extend or withdraw credit lines as their analysis of circumstances dictates

(See answer to Question 50 in bank survey). Such analysis may include attempts to determine whether rescue efforts might be forthcoming only for large and/or government-owned banks. Once a bank is actually known or believed to be in distress, continued extension of credit from other banks rests on the belief that the authorities will provide support. Some banks will then continue to lend in an effort to maintain confidence in the system and avoid crisis while others withdraw deposits or lines; some banks that continue to extend credit may be additionally motivated by the opportunity to take advantage of relatively high rates and the hope of benefiting, over time, from having proved themselves "friends in need".

The Response of Major Central Banks

With the events of 1973 and 1974 as a catalyst, recognition of the potential need for concerted action in the event of international problems was considered at a meeting of the world's major central banks in Basle in 1974. The statement they issued reflected the classical model, that is, public concerns should be put to rest with assurance that support is available but, in order to keep the markets disciplined, the exact circumstances under which support would be forthcoming should not be formally specified. Specifically, the Governors of the G-10 and Swiss central banks announced that, after considering the problem of lender of last resort in the Euromarkets, "they recognized that it would not be practical to lay down in advance detailed rules and procedures for the provision of temporary liquidity." But they were "satisfied that means are available for that purpose and will be used if and when necessary."

Conclusions

The study group believes that some degree of ambiguity is a necessary feature of a lender of last resort facility. Any move to spell out specific terms and conditions under which assistance would be made available to banks in distress would have the detrimental effect of undermining market discipline. At the same time, the strong views of commercial banks that there is a need for clearer understanding of lender-of-last-resort facilities were noted.

6. COMPETITION, PROFITABILITY AND CAPITAL

In explaining the narrow spreads on international loans bankers give greatest weight to supply and demand conditions and to aggressive pricing by lenders seeking to enter new markets or expand market share. The entry of new banks into the Euromarket and expansion of international activities by previously established institutions have obviously maintained intensely competitive conditions. For example, data on syndicated loans collected by the World Bank suggest that there may be as many as 10 times the number of lending institutions in the syndicated loan market today as there were in 1972. Of those that the World Bank identified by name (institutions in the first nine or ten manager positions), one-third of 1980's syndicated loan managers are headquartered outside Europe or North America, compared to only one-eight in 1973: See Appendix C.

Concerns

Perceptions of increasing risk in international lending are frequently accompanied by concern that, with spreads on loans squeezed by intense competition, returns are not commensurate with risk. Moreover, there is concern that the narrow margins lead to lower profits, thus impairing banks' ability to maintain adequate capital ratios.

The remainder of this section will explore the following questions:

- What is the relationship between quoted spreads and bank profitability?
- How have banks responded to narrower margins?
- Does competitive pressure come particularly from some banks with competitive advantages?
- What has the supervisory response been?

The Effect of Spreads on Profitability

Quoted spreads are a guide to establishing borrower costs, not measuring profit margins, if only because banks' average costs of funds are usually below LIBOR, front-end fees on loan agreements provide further compensation and there is the unquantifiable benefit of other business kept or gained.

In general, large banks enjoy wider gross lending margins because of their lower average cost of bought-in funds. They and banks that take lead roles are more likely to gain more also from fees and related business. Participants that do not have such advantages — or have them to a lesser extent — have some offsetting benefit, however, since they do not incur as much indirect (non-funding) costs as the lead banks.

The question of what level of spreads is "acceptable," i.e., likely to generate an adequate net return, is a very difficult question for any individual bank. Analysis of the profitability of international lending, and international operations generally, poses problems which include allocating indirect costs. It has been reported that many bankers have been dissatisfied with their own internal data and profit-center analyses. The difficulty of accounting for the true economic cost of rescheduled loans, discussed earlier, further complicates the issues.

Follow-up interviews to a previous Group of Thirty survey yielded some "*guesstimates*" on profitability from non-U.S. banks. Most estimated their true gross return at about *0.25 per cent* above quoted spreads. Also, most estimated their breakeven point at about ⅜ per cent over LIBOR plus some elements of front-end fees.[11]

The record shows that individual lenders are not able to stop the erosion of loan spreads. Since banks feel in many cases compelled to maintain market presence, the principal results of a bank's attempt to hold the line at a given "acceptable" spread may be a deterioration in the quality of its loan portfolio.

Sources of Pressure on Margins

Some banks have competitive advantages that arise from the regulatory regime within which they operate. Highly leveraged banks can lend at relatively low margins and still earn a reasonable return on equity. Also, because there is less emphasis on profitability, some government-owned banks or savings banks may have a similar pricing advantage. Finally differences in reserve requirements and other regulatory measures can also have an impact on competitive abilities of banks, especially if they were to be manipulated to promote or discourage international activities.

However, not all competitive pressure comes from banks with regulatory advantages. For example, sluggish domestic loan demand may lead to more aggressive pricing by banks from different countries at different times. Also, more recent entrants may at any given time be competing more aggressively to gain market share or carve out a special niche. Finally, even the more established institutions may adopt a competitive strategy of cutting price to increase market share. Waves of intense competition from various groups of banks tend to maintain the pressure on margins.

Such competitive pressures in the market are expected to continue. The bank survey identified varying capital requirements as the main factor distorting competition, in the view of bankers. Differences in regulation were thought by a majority to be "somewhat" important factors affecting competition.

Supervisory Capital Requirements

The continuing decline in spreads, since 1976, in spite of some recent recovery, and perceptions of increased risks in the market, has prompted special attention to capital adequacy on the part of banking supervisors from the major industrialized countries. Germany and Switzerland, for example, have recently widened the scope of their capital requirements in order to encourage their banks to increase provision for the risks they incur in their international activities. A brief outline of capital adequacy requirements is given in Appendix D.

---

[11] "The Outlook for International Bank Lending", G-30, August 1981. It should be noted that these guesstimates were highly qualified since many respondents indicated they are not able to monitor efficiently their marginal cost of dollars, and most admitted that inability to allocate overheads, etc., made costing unreliable.

To the extent that capital requirements are effective, they should ultimately constrain expansion of lending when returns are inadequate. Reportedly, some Swiss and German banks have reduced their international lending activity in reaction to new or proposed requirements, and some banks in London claim to have been constrained by Bank of England capital adequacy guidelines, although it is not clear whether this has had any direct impact on their international business. A previous Group of Thirty survey revealed that respondents' banks believe capital adequacy will be one of the more important constraints on future international lending, although not necessarily a very significant one.

The BIS, in its April 1980 communique, listed capital adequacy as one of the three elements of international banking soundness to which the central bank governors attach "cardinal importance", and endorsed the efforts of the Cooke Committee in this area. It seems likely pressure by national authorities to sustain adequate levels of capital will continue, and will be beneficial for the protection of the earning capacity of the international banking system as a whole. This may be accompanied by some move towards convergence of different countries' capital adequacy standards, although this is likely to be a fairly long-term prospect.

Conclusions

It is the opinion of the study group that supervisors should not attempt any direct action to increase loan margins. There may in any event be practical limits to the efforts of individual supervisors, because of possible disadvantages to their banks from prudential requirements that are significantly more stringent than their competitors'. For that reason, cooperative efforts among supervisory authorities are a very positive development. The bank survey revealed support for the view that requirements should be harmonized — with a preference (perhaps not surprisingly) for achieving this by reducing rather than raising regulatory requirements.

7. FURTHER SUGGESTIONS FOR REDUCING RISKS IN BANKING

The purpose of this concluding section is to explore two suggestions for reducing risk — through a requirement for banks to make provision for rescheduled loans and, secondly, by way of improving the arrangements for dealing with rescheduling and the flow of information on international indebtedness. These are in addition to the recommendations made in the preceding sections of this report.

Provision For Rescheduled Loans

A recently topical subject has been the question of whether banks should be obliged to make provisions against loans that are to be rescheduled. The question is whether regulators ought to move towards requiring the making of some provision against a portion of rescheduled loans at the time of rescheduling. To put it another way, rescheduling — de facto — indicates the existence of a loan quality problem. Even if this problem is presumably resolved through an agreed rescheduling, there is no reason to doubt that the lending institutions' judgment at time of loan origination had not been borne out. Consequently, provision against possible loss or a provision for opportunity-loss seems prudent and reasonable. It is the opinion of the study group that, as reschedulings may become more common, it would be in the interest of banks to make some provision against rescheduled debts either specifically or through the existence of some general provision of adequate size and, unless circumstances are exceptional, supervisors should encourage action on these lines.

Those who argue against this point of view note the following:

1. There is little international uniformity in the treatment of non-performing and rescheduled loans. Obviously, the inequity posed by differing rules and differing standards can be used as an argument to frustrate the basic concept of provisions for rescheduled sovereign loans. However, individual regulators could proceed along lines they deem to be best for the safety and soundness of their banking system even if other regulators are more lenient.
2. A second argument is that the requirement for rescheduling can be solved by bank refinancing. Rescheduling might be avoided by increasing loans to cover interest and/or principal payments. This technique is obviously nothing more than putting off the day of reckoning; it amounts to the same thing as a rescheduling and lacks conviction.
3. A third argument in opposition to provisioning has been that it weakens creditors' negotiating position and might tempt debtor nations not to fulfill their obligations, although there is little evidence to suggest that this has been a feature in rescheduling activities to date.

On the positive side, the argument for provisioning is that:

1. The rescheduling is, in and of itself, an indication of loan-quality problems. Such quality problems should be recognized and some portion of the rescheduled loan should be reserved both as an indication of the reality of the loan quality problem and also because of the costs involved in rescheduling, not the least of which is the opportunity cost.
2. Provisioning reinstills into sovereign lending one element of discipline

which may have diminished substantially over the past decade as losses in international lending have been contained due to rescheduling activities.

Clearly, the problems concerning provisions for losses and rescheduling activities are substantial. On the other hand, a more rigorous approach could help improve discipline within the international banking system. In addition, it would discipline the sovereign borrowers and strengthen forces making for better balance of payment adjustments. In sum, the study group believes that it is appropriate for all supervisory and regulatory authorities to encourage banks to take action in this area, although it is recognized that it is unlikely that this will be possible at least initially in any uniform way.

Inadequacies of Existing Arrangements

The study group feels that the existing arrangements among banks to deal with country debt reschedulings are unsatisfactory, being almost entirely of an ad hoc nature. In particular, the period leading up to renegotiation has been extended, to the detriment of all parties, by the need for lending banks to be persuaded to join together, pool information and appoint negotiators (recent experience has shown that it can take a long time before the major banks even know what other banks are involved). Also, the study group notes that the assembly process in respect of gathering information on cross-border claims of commercial banks is incomplete and needs to be improved.

A good example was that of Turkey where the first estimates of lending proved to be far lower than the total which emerged when banks and other creditors revealed their individual lending figures. The same happened in the case of Poland. The study group feels that it would be in the best interests of both debtor countries and creditor banks if it were possible to have a central unit in which statistics on international lending were kept complete, up-to-date and confidential. This might be undertaken by the BIS, building on their existing work, or conceivably by a new organization established by the banks themselves.

Clearly, the combination of a prolonged recession, falling commodity prices and historically high levels of real interest rates in most major countries and especially in the United States could lead to further strains appearing in the banking system, especially if a number of reschedulings were to take place either simultaneously or within a short space of time. It might well be that the banks would react to an increase in perceived risk by cutting back international lending. If the same phenomenon applied to the inter-bank market, an individual bank could find it difficult to renew deposits in the inter-bank market, thus setting off a contraction in liquidity. While these risks exist whether arrangements for rescheduling of country debts are efficient or inefficient, the study group feels that the level of risk is unnecessarily increased because there is no generally accepted and readily activated mechanism for dealing with a potential escalation of such problems. By contrast, it was noted that in the case of official government creditors, once a country finds itself in difficulty, the Paris Club can be convened and the government creditors are able to react quickly and in unison to a common problem.

The same point applies to relationships between commercial banks and the International Monetary Fund and the World Bank. No formal (or even informal) system exists whereby representatives of commercial banks as a group and officers of the International Monetary Fund can meet regularly to discuss mutual problems. Naturally, the study group recognizes that the IMF and the World Bank would find it difficult, if not impossible, to initiate discussions with commercial banks on country problems for fear of being accused by member countries of favoring such creditors. However, it is felt strongly that this legitimate concern does not obviate the need to establish means of better communication. The overriding consideration is to establish a method or forum whereby the major actors in international lending, namely the commercial banks, the multilateral official institutions, and government creditors could find a way of working more closely with each other and with borrowers both to improve the flow of information and to react quickly in case of need.

A Consultative Group for International Banking?

The study group felt that the more rapid the action of the main actors in dealing with a debt rescheduling need, the more likely would it be that a country could resolve its problems in a timely manner without being subject to a precipitous withdrawal of credit and hence possibly unnecessarily severe domestic economic adjustments. Among various ways in which such prompt action could be encouraged the study group gave close consideration to initiatives that might be taken by the private sector of the international financial community.

One area in which further improvement is required, as noted previously in this report, is in the collection and timely dissemination of statistics on the liabilities of countries to the banking system and capital markets.

Data on international bank lending is already gathered by the World Bank and the Bank for International Settlements, but a banking bureau which could supplement information from such sources by obtaining additional information from borrowers or lenders could play a useful role in increasing the 'transparency' of the market (for example, by gathering information on the exposure of banks from different countries to particular sovereign borrowers, lending by banks outside the Group of Ten and

Switzerland, the positions of official and other non-bank creditors, and movements in short-term credit flows).

Beyond such initiatives to improve information could come the establishment of some forum (an "International Banking Consultative Group"?) in which leading international bankers would be able to discuss issues of mutual concern. It might also be able to liaise on behalf of bankers with official international and government agencies, providing these bodies with an additional forum for discussing problems concerning international capital flows and market regulation. Equally important, it would be available as an additional channel through which borrowers would be able to convey their views more effectively to the international banking community at large.

This role as a "channel of communication" might over time be found particularly useful in connection with international debt servicing problems. The body could not itself represent banks in rescheduling negotiations, but could in certain circumstances occupy a liaison role between bankers and borrowers, and between different banking interests in a problem loan situation. The possibility of conflicts of interest must be acknowledged, given that the group would be composed of bankers who are themselves active in the international field, but the group would be in a good position to look beyond such interests and focus on factors of longer-run importance.

Past experience has shown that debtors as well as creditors have much to gain from improvements in the machinery for dealing with debt problems. It would be for the "consultative group" to demonstrate through its actions that its role is a constructive one, and not narrowly sectoral in outlook. It could provide the means for bringing involved banks together quickly once a rescheduling request had been received, and in due course could be expected to develop expertise that would be of great assistance to negotiators of both parties. A "consultative group" could not, of course, have legal powers to enforce decisions, but would derive its authority from the standing of its members, the expertise of its secretariat, and from the moral support given to its work by the international banking industry. It would certainly be important to discuss the objectives of the new body as widely as possible, to demonstrate the positive role it is intended to play, and to take full account of the views of sovereign borrowers.

New patterns of international financial flows will be called for in carrying through the volume of international lending needed in the 1980's. These may include expanded use of co-financing, parallel lending and similar techniques. Progress in these directions, which has so far been disappointing, might well be facilitated if there was in existence an authoritative body amongst commercial bankers with which the international agencies could co-ordinate their thinking and establish acceptable ground rules for co-operation and joint development.

The study group fully recognized that there are likely to be many difficulties in setting up such a group. For example, the question of whether members should be formally representative of their respective national banking communities or selected in another manner would require careful consideration. On the one hand, in view of the fact the Euro-currency markets have developed on a transnational basis and that sectionalization of interest along national lines could be counter-productive, it may well be best to avoid members being nominated by national banking communities. (There is also the possibility of anti-trust conflict to be considered, though this should not be exaggerated). On the other hand, national representation would provide a more formal element of structure to the Council and perhaps strengthen its moral authority.

More generally, these areas of difficulty might be found less of a problem if in the first instance an experimental body were to be established on an informal basis. It would then grow when experience was gained, thus helping to avoid the problem of unrealistic expectations, and by this means enjoy greater freedom to set a style for future operations. Private discussions indicate that a wide measure of support exists, both inside the banking industry and among interested outside parties, for the concept of a representative international body of the kind discussed in this paper.

APPENDIX A

Commercial Banks' Attitude to Country Risk Assessment

It is possible that the 1980s will see an increase in the number of countries experiencing difficulties in the servicing of their international debts. A system which aids the early identification of such countries must, therefore, be an essential tool in the effective management of a commercial bank's lending portfolio. Concomitantly, such a system can make an invaluable contribution to the formulation of a commercial bank's marketing plans by identifying areas with potential for profitable and creditworthy lending opportunities.

This appendix attempts to summarize the "state of the art" of country risk assessment within the commercial banks with the aim of stimulating discussion on the appropriateness of the banks' approach to selected risk factors and their evaluation. The approach adopted in this analysis has been to review a number of systems which have been employed or proposed for the evaluation of country risk and which have been outlined in various recent published articles and other material. The majority of these articles relate to specific systems which are actually in use in a major international bank. (For definitions of terms, see page 6, footnote 3).

Diversity of Risk Assessment Methodology

In 1977 the Federal Reserve's Committee on Foreign Lending examined the international lending practices of 46 member banks. The study revealed that all those banks had internal systems for monitoring and controlling foreign lending but there was substantial diversity in the level of sophistication of the techniques used.

Similar research undertaken by Eximbank in the same year confirmed the variations in the methodology adopted by banks in the evaluation of sovereign risk. The Federal Authorities introduced in 1978 a paper entitled "A New Supervisory Approach to Foreign Lending" which clearly indicated that they expected each system to exhibit general characteristics, including risk assessment based on reliable and up to date information.

In practice it is difficult to envisage how such uniformity can be achieved, particularly bearing in mind the diversity of existing systems and perhaps, more importantly, the complexity and attendant problems appertaining to country risk assessment. The main problems identified are outlined under the appropriate headings in the ensuing sections.

Key Factors and Common Elements of the Systems Reviewed

For the purpose of this review of country risk assessment, eleven systems have been analyzed. A list is outlined at the end of this appendix.

The eleven systems reviewed have certain broad common factors and, in our analysis, we have grouped these into economic and political/social factors. This grouping broadly mirrors the distinction embodied in the systems themselves, which differentiates between a country's ability to service its debts (as measured by economic factors) and the extent to which the ability to repay debts is affected by political considerations (political factors).

A schedule indicating the economic and political factors taken into account in the systems reviewed is shown on pages 45 and 46.

Economic Indicators

The economic indicators which emerged from the analysis as being fundamental to country risk assessment were:

— the debt service ratio, i.e., $\frac{\text{debt service costs}}{\text{export earnings}}$
— the balance of payments position
— the exports growth trend
— the level of internal economic growth expressed in terms of one of the major economic aggregates such as gross national product (GNP) or gross domestic product (GDP).

It is evident that export performance, and hence a country's ability and capacity to generate foreign exchange, is a crucial factor. Current and expected performance in this area must, therefore, be one of the essential indicators in developing a meaningful system of country risk assessment.

An important question therefore must be: how accurate and up to date is the available data on exports and the other factors with which it is compared for analysis purposes?

Exports

One of the main sources of information on exports themselves is the International Monetary Fund's monthly publication "International Financial Statistics" which provides a reasonably accurate current account position and balance of payments trend. In addition, because these statistics provide a break-down by major product, the dependence of a country's economy on selected exports is available.

External Debt

The availability and accuracy of information in respect of a country's external debt, and particularly its constituents, is a problematical area which in turn influences the reliability of the debt service ratio. If such information is not sufficiently comprehensive or accurate, then the reliability of this risk assessment tool is in doubt. This is clearly a matter of importance, since most of the systems reviewed in this paper make extensive use of this ratio in their evaluations.

Improved data, in isolation, would not, however, resolve the problems associated with projecting this measure into the future. These problems arise because predictions of the debt service ratio should include assumptions concerning future interest rates and the levels of future borrowings.

The latter is calculable by reference to projected future balance-of-payments deficits and the extent to which these will be financed by increased borrowing. However, it is open to question whether this approach is satisfactory because assumptions concerning increased borrowing automatically imply that a country is creditworthy — the very fact which the analysis (including projected debt service ratios) is seeking to determine.

It must also be borne in mind that, to satisfy their borrowing requirements, certain countries could be recipients of loans at favorable interest rates and/or terms ('soft loans') akin to aid which would distort projected debt service ratios.

Similarly, the problem of the accurate prediction of interest rates cannot be easily resolved. The volatility of US interest rates over the last two years is clear evidence of this. Therefore, a relevant question is how the quality of the data necessary to formulate accurate projections can be improved.

Major Economic Aggregates

The data on which measures of growth in GNP and GDP are calculated emanate primarily from World Bank sources and, like the debt figures, suffer from production delays.

Despite the fact that a country with a rapid growth rate would appear to be a sounder economic prospect than one with a contracting economy, experience tends to show that there is little apparent connection between risk and either GNP/GDP totals or growth rates in these aggregates.

The question must, therefore, be asked: why are such indicators, which correlate poorly with historic rescheduling experience, often included in risk assessment systems? Is it because they are generally accepted as the most important indicators which modify the overall view of a country as presented by the export related indicators? If so perhaps these indicators should be seen as a checklist of the thoroughness of the assessments made in arriving at a country's likely export performance.

Other examples of such modifying indicators include:

- the inflation rate,
- the growth in a country's capital stock as measured by the level of gross capital formation,
- the economic diversity within a country,
- money supply growth rates.

Overall one could speculate whether, in fact, these qualitative indicators do contribute to the operational success of an economic analysis system. If it can be shown that they do not contribute, could the argument be advanced that the examination of factors, other than those relating to exports and indebtedness, is unnecessary?

Political Indicators

The need to define terms clearly is even more imperative when considering political factors. However, it is possible to identify two main groups of factors which are felt to be fundamental to the assessment of political risk. .

These are:

- the factors which indicate the ability of a political system to accommodate change without serious disruption, and,
- the factors which identify factions within a political system which may seek to cause disruption as a means of change, either on religious, political or ethnic minority grounds.

Both these groups of factors relate to the political stability of a country with particular reference to its prospects for the future, this being felt to be the main aim of any political analysis.

It is , however, pertinent to emphasize at this juncture that, during the 1970s when the level of international lending substantially increased, the incidence of ultimate loss from state risk lending was minimal. This cannot reasonably be attributed to a high level of political stability during this period. Rather, experience has shown that no country can completely isolate itself from world events and that whatever local circumstantes may prevail, it must maintain certain standards which include the honoring of international commitments if it wishes to continue to enjoy commercial links with other states and institutions. A recent example as far as the commerical banks are concerned is Iran. It has repaid the majority of its international debts although it is recognized that certain other obligations remain outstanding.

The question may, therefore, be asked: in what way is the analysis of political stability generally relevant and necessary within a country risk assessment system?

The question need not infer that political analysis is totally without use but implies, as in the case of the qualitative economic indicators, that the aim of any system may be not so much to avoid situations of absolute default but to identify and hence minimize the risk of temporary disruption and of rescheduling.

Systems Used to Combine Economic and Political Indicators

One of the main problems associated with these methodologies is how to combine the two elements in one assessment, and in this regard, the inter-relationship that inevitably exists must be borne in mind.

This inter-relationship means that, in combining economic and political factors into an overall country score, care must be exercised not to recount, under political variables, those already fully reflected in the economic score.

Commercial banks have not been deterred, however, from seeking systems which take into account both types of factors in establishing an overall rating.

In analyzing the manner in which the systems used by banks combine economic and political indicators to arrive at a country risk rating, it is interesting to note that all the systems surveyed gave details of economic factors used in the systems but only eight gave details of political influences.

The manner in which credit risk assessment is practiced in any one of the institutions surveyed is influenced by the following factors:

a) the size of the institution and the level of expertise;
b) the involvement of the institution in the international lending market:

The nature of the analysis undertaken has inevitably meant that it has concentrated on larger institutions with significant presences in the international lending market. Because of this, it was to be expected that the commercial bank systems reviewed would exhibit relatively high levels of sophistication.

The majority of banks have concluded that an approach combining statistical analysis with a more descriptive method, and covering both economic and political factors is best suited to their needs. This method, known as a "structural/qualitative" approach, recognizes the limitations of both a purely statistically based system ("checklist" approach) and the shortcomings of the much looser "unstructured" approach or the exclusively "qualitative" approach.

The Place of the System in the Decision-Making Process

The Aim of the System

The general aim of the banks whose systems were reviewed has been to produce a system capable not only of identifying possible future defaults or reschedulings but also to aid the evaluation of the risk/reward relationship of any particular country. As already indicated above, this latter aspect is particularly relevant in the formulation of a commercial bank's marketing strategy.

Thus, as well as being one of the management tools used when assessing individual loan propositions, a country risk assessment system has an important role in the setting of country limits and the making of investment decisions. However, other important factors need to be taken into account such as the rate of return, strategic marketing decisions and lending portfolio considerations.

Whilst it is self-evident, it is important to stress that, for a risk assessment system to achieve its objectives, those operating the systems must fulfil these three conditions:

— they must possess an in-depth country knowledge,
— they must have a full awareness of those factors inherent in a successful country risk assessment system,
— they must possess the expertise necessary to identify and use the relevant data and, equally important, they must be able to analyse and interpret the conclusions in a constructive and balanced manner.

Other Considerations

Before examining other factors which will influence country risk assessment, it is worth noting that the systems reviewed are more applicable to the major international banks. It is nevertheless essential that all banks arrive at an independent judgment on all syndicated lending decisions and in this connection, lead managers generally incorporate into loan agreements a clause stating that participating banks are solely responsible for undertaking their own independent appraisal of the risks appertaining to a loan.

Some other considerations relevant to the risk/reward relationship are:

- — the frequency with which a borrower approaches the market,
- — the skill of the negotiators — both lenders and borrowers,
- — a commercial bank's existing exposure to a particular country and its need to maintain a balanced lending portfolio. Indeed this is one of the crucial factors and the principles of balance will be maintained irrespective of the assessment of country risk.

Future Prospects

The early 1970s was a period of growth in the Euromarkets and, during this time, as the number of banks involved in this sector increased and international liquidity expanded, most countries were able to fund even debt servicing by expanded borrowing. If this was not possible, countries were able to reschedule their loans in all except the very worst cases. As a result of these conditions, and the attendant low level of losses, there has been little apparent urgency to develop sophisticated systems because it has been possible to operate successfully without any formal system for minimizing country risk other than a balanced lending portfolio.

In more recent years, however, the influences of diminishing margins, at least in terms of prime borrowers, the slow down in the rate of growth which reduces demand from the corporate sector in the industrialized countries, and increasing competition for loans to the "better risk" developing countries, have combined to force banks looking for profit to turn towards "second tier" borrowers. This has occurred at a time when, for many countries, conditions have been worsening as the impact of rising oil prices, falling commodity prices and high interest rates has been felt.

There is no evidence that this trend in events is likely to alter dramatically. Banks are now being required to manage greater risk in their portfolios, and to seek more aggressively for satisfactory returns. It may, therefore, be expected that country risk analysis will continue to increase in importance.

Nevertheless, the quality of any system of analysis will still be dependent upon the standard of information which is input. In this regard, the World Bank, for example, is continually seeking to upgrade its information on countries' debt.

This is not to say that systems will necessarily monitor more variables: rather, that the standard of forecasting and understanding of each variable's significance should become better developed. There could also be a move towards more sophisticated models based on covariance at least for asset allocation purposes. This will involve a global approach to country risk, evaluating world events in terms of their overall effect on a portfolio of borrower countries.

Key Factors in Future Risk Assessment

Since Cuba and Ghana in the 1960s, no major borrowing country has deliberately repudiated its international debt, and this has led to the assumption, which was previously alluded to in this paper, that economic factors are paramount in assessing country risk. It may be that this assumption will gain further support and possibly, in future years, systems should focus even more on the economic factors. This is not to say that in future there will be a dramatic slackening in the pace of state risk borrowing.

The view is not, however, universally held, and it is not impossible that changes of regime in certain developing countries could conceivably lead to a repudiation of debts incurred by previous administrations.

Indeed, in view of the comparative sophistication in economic modelling and the fact that current political assesssments are adequate for most normal situations, it could be that this aspect of unpredictable repudiation of debts could become the greatest absolute threat to international lenders in the future. An ability to assess this kind of risk will depend on an enhanced level of political analysis, including major studies of opposition groups in many countries.

When undertaking state risk lending internationally, banks expect to be repaid on schedule either by the borrower generating sufficient foreign exchange or by refinancing its debt. In a large number of countries, the level of external debt is relatively small in terms of the overall size of the economy and, therefore, repayment or refinance presents little problem.

However, if balance of payments deficits persist in certain instances the level of external debt and the burden of debt servicing will continue to increase and will become major problems. In cases such as this where, at the current time, a country is experiencing difficulty in servicing its debt from foreign exchange earnings, its ability to refinance existing debt depends upon it being seen to be moving progressively towards the required level of foreign exchange earnings. Therefore, it is at least arguable that future risk assessment systems should develop further the capacity to monitor countries' progress in this respect.

NOTES

Definitions Relating to Country Risk Assessment Systems

UNSTRUCTURED APPROACH

This approach involves no systematic or regular analysis of a country's position but relies upon opinions held on each occasion when a decision as to the creditworthiness of a country is required. There is no attempt made to 'rank' countries or to assess relative risk/reward ratios.

CHECKLIST APPROACH

This approach involves using a 'scoring' technique to scale a country's performance with respect to prespecified variables. It is quantitative in character and suffers from the exclusion of other variables which may have relevance to the overall assessment.

QUALITATIVE (OR DESCRIPTIVE) APPROACH

This system, based on country evaluation reports which vary in detail from country to country, focuses on each country's unique attributes and problems. The principal disadvantage is that evaluation may vary substantially between countries making comparisons difficult. Moreover, evaluations tend to be retrospective rather than prospective.

THE STRUCTURED/QUALITATIVE APPROACH

This approach uses a standard format for all countries, thus facilitating comparison, it covers both political and economic factors and involves a degree of statistical analysis where appropriate. Because it relies not only on statistical data but also on expert opinion it is able to combine the advantages of the Qualitative with statistically based methods such as the Checklist Approach.

COVARIANCE

This will involve a global approach to country risk, evaluating world events in terms of their overall effect on a portfolio of borrower countries. For example, an oil price rise, whilst of benefit to OPEC countries, has a detrimental effect on the non-oil LDC's.

ECONOMIC FACTORS

COMMERCIAL BANKS' ATTITUDE TO COUNTRY RISK ASSESSMENT

SCHEDULE OF FACTORS USED IN THE INDIVIDUAL SYSTEMS REVIEWED AT APPENDIX II

Measure~	Systems Reviewed (see key at foot of page)										
	A	B	C	D	E	F	G	H*	I	J*	K
Debt service ratio	X	X	X	X	X		X	X	X	X	X
Imports/Reserves ratio	X			X		X		X	X		X
Capital/Debt ratio	X			X		X		X		X	
Income per capita	X	X	X	X				X	X	X	X
Income growth rate	X	X	X		X	X	X	X	X		X
Export growth rate	X		X	X	X		X	X	X		X
Export analysis		X	X		X	X	X	X	X	X	X
Imports/Exports ratio		X	X	X	X	X	X		X	X	X
Economic diversity		X	X			X			X		X
Exports/GNP		X	X	X						X	X
Level of IMF support/Reserves ratio		X		X	X	X	X	X	X		X
Debt structure		X					X	X	X	X	X
Inflation/Monetary/Fiscal policy		X	X	X	X	X	X	X			X
Physical resources			X	X		X	X	X	X		X
Debt			X	X		X	X	X	X	X	X
Import analysis			X	X	X		X	X		X	X
Basic strength		X	X	X			X				X
Ability to change peacefully		X		X		X	X	X			X
Likeliness of internal conflict		X				X	X	X	X		X
Policies of ruling group		X	X			X					X
Philosophy of ruling group		X									X

COMMERCIAL BANKS' ATTITUDE TO COUNTRY RISK ASSESSMENT

SCHEDULE OF FACTORS USED IN THE INDIVIDUAL SYSTEMS REVIEWED AT APPENDIX II

Ability of government officers	X				X	X	X		X
Flexibility of the political system	X						X		
External relations	X				X		X	X	X
Minority groups	X	X		X		X		X	X
Religious problems	X			X		X		X	X
Unemployment	X	X				X			X
External ethnic problems	X		X			X		X	X
Government support		X				X			X
Type of system		X				X	X	N/A	X
Opposition groups					X	X		X	X
Wealth disparity		X				X		X	X

~ In some cases similar measures from two or more systems are grouped together under one heading. For example, "Income per capita and Income growth" are taken in terms of either GNP or GDP

* Systems H and J allude to a comprehensive political analysis but factors are shown above only where detailed in the articles.

KEY TO THE SYSTEMS REVIEWED:

A Feder/Ross: World Bank (G. Feder and K. Ross) 1977
B C.M. Korth, University of South Carolina, Ex First National Bank of Chicago 1979
C J.N. Robinson, Chase Manhattan Bank NA (1981)
D K. Janoeri, Union Bank of Switzerland (1980)
E Amsterdam and Rotterdam Bank NV (1980)
F Business International Country Risk Assessment Service (1981)
G P.S. Nagy, Bank of Montreal (1978)
H H.R. Heller, Bank of America (1980)
I P. Gutman, National Westminster Bank Ltd. (1980)
J American Express Bank (1980)
K A. Von Agtmael, Bankers Trust Co. (1976)

List of Systems Studied

1. *Authors:* G. Feder and K. Ross, Economists at the World Bank
   Article: Quantitative Creditworthiness Indicators are useful
   Publication: World Bank Publication.
   Date of Publication: December, 1977
   Aim: To quantify the probability that a country will reschedule at least part of its foreign debt in some future year.
   Indicators reviewed: Economic only

2. *Author:* A.W. von Agtmael, Vice President Bankers Trust Co. and Managing Director (designate) Thai Investment & Securities Co., Bangkok
   Article: Evaluating the Risks of Lending to Developing Countries
   Publication: Euromoney
   Date of Publication: April, 1976
   Aim: To analyse country risk from the point of view of a commercial bank making term loans to *developing* countries.
   Indicators reviewed: Economic and Social/Political

3. *Author:* C.M. Korth, Associate Professor of International Business, University of South Carolina (formerly Credit Analyst, First National Bank of Chicago).
   Article: Developing a Country Risk Analysis System
   Publication: Journal of Commercial Bank Lending
   Date of Publication: December, 1979
   Aims: To minimize the risk in a bank's foreign portfolio. (Risk in this instance includes default, moratorium, forced rescheduling or excessive delays in repayment of principal or interest on a national scale).
   Indicators reviewed: Political/Socio-Cultural and Economic.

4. *Author:* P. Gutman, Manager, Market Intelligence Department, National Westminster Bank
   Article: Assessing Country Risk
   Publication: National Westminster Bank Review
   Date of Publication: May, 1980
   Aims: To provide an assessment and classification of foreign countries from the point of a commercial bank involved in international lending.
   Indicators reviewed: Political and economic

5. *Author:* J.N. Robinson, Senior Economist, Chase Manhattan Bank
   Article: Is it Possible to Assess Country Risk?
   Publication: The Banker
   Date of Publication: January, 1981
   Aims: To identify countries which will fail to generate enough foreign exchange to service their foreign debt.
   Indicators reviewed: Economic and Political/Legal

6. *The Business International System* (BI)
   Authors: Business International
   Article: Business International Country Risk Assessment Service
   Article: Business International publication
   Date of Publication: 1981

Aims: To identify and quantify country risk in a system designed to meet the widest range of corporate planning and forecasting needs.
Indicators reviewed: Political, economic and financial

7. *The Amex Bank System*
Authors: Amex Bank Economics Unit
Article: Country Risk Analysis and Decision Making in an International Bank. The Approach at American Express International Group
Publication: Amex Bank Economics Unit publication
Date of Publication: January, 1980
Aims: To provide quality analysis of country risk, using all available resources and to thereby improve the bank's spread of assets world-wide.
Indicators reviewed: Economic and Political

8. *Author:* P.J. Nagy, International Economist, Bank of Montreal
Articles: a) Country Risk-How to Assess, Quantify and Monitor It
b) Quantifying Country Risk-A System Developed at the Bank of Montreal
Publications: a) Euromoney Publications
b) Colombia Journal of World Business
Date of Publications: a) December, 1978 b) Autumn, 1978
Aims: To quantify country risk by comparing the risks of investing in nations among which size, levels of economic development and political and institutional structures differ.
Indicators reviewed: Economic and Political

9. *The Amro Approach*
Article: Country Risk Analysis & Lending Policies — The Amro Approach
Publication: Amro publication
Date of Publication: February, 1980
Aims: A model to assist in portfolio development with regard to risk, return and volume.
Indicators reviewed: Economic and Political

10. *The Bank of America System*
Author: H.R. Heller, Vice President, International Economics, Bank of America.
Article: Bank of America's New Currency Evaluation System. (AMR — Euromoney conference on country risk assessment).
Date: 30 October, 1980.
Aim: To analyse a country's capacity to service its foreign debt.
Indicators reviewed: Economic and Political

11. *Author:* K. Janjoeri, Senior Vice President, Union Bank of Switzerland
Article: Assessing Country Risk
Publication: UBS International Banking publication
Date of Publication: June, 1980
Aims: To provide an indication as to the creditworthiness of any country to whom UBS may choose to lend.
Indicators reviewed: Economic and Political

APPENDIX B

The Rescheduling of Country Debt: Is a More Formalized Process Necessary?

Richard Huff

Introduction

With the growing importance of commercial bank lending in international financial flows in the 1970s, it was inevitable that country debt service crises would take on a new flavor. The debt reschedulings that resulted from such crises were not new or unprecedented, of course. Reschedulings of official debt had become fairly commonplace ever since Argentina had asked its government creditors to reschedule in 1956; ten countries engaged in 31 separate reschedulings over the two decades 1956—75. Such multilateral exercises had, in fact, become fairly routine through the procedures of the Paris Club, an informal group of major Western creditor governments chaired by the French Treasury.[1] And, while the rescheduling of debt owed to private creditors was less frequent, it was by no means unheard of; several countries — including Argentina, Brazil, and Chile — had rescheduled their private debt in the 1960s and early 1970s.

What distinguished the reschedulings of the later 1970s, then, was not so much their novelty as their scope. Instead of the relative handful of banks, often from a single country that once had been involved in negotiations, there were now 100, 200, or more. (Poland is currently attempting to reschedule debts owed to some 500 separate institutions.) And where a few million dollars were once at issue, the stake had grown to the hundreds of millions, or, in some cases, billions of dollars.

This increase in the scale of the reschedulings suggests a corresponding increase in their complexity — a complexity manifested both in the substance of the talks as well as the mechanics of a process involving so many participants. And it calls into question whether the ad hoc approach that has previously been taken toward the organization of these negotia-

---

Richard Huff is Financial Analyst in the Strategic Analysis Division of the Office of the Comptroller of the Currency in Washington.

tions will continue to be effective in the reschedulings of the '80s. That approach, to be sure, has thus far been adequate to the demands placed upon it. No rescheduling talks have failed simply because of organizational difficulties in starting a new rescheduling process from scratch each time that banks and debtor governments decide to enter into negotiations. And the flexibility afforded by the absence of a more formalized process has perhaps aided in the resolution of difficult substantive issues.But "ad-hocery" has had its costs — notably the confusion and delay in resolving difficult organizational and procedural questions before substantive discussions can begin. And if reschedulings become more numerous and frequent in the years ahead — as many observers predict — it is well worth considering whether the process for conducting them ought to be more formalized and institutionalized.

This paper will examine that question. We will begin with a review of the rescheduling experience of the past half-dozen years, focusing in particular on whatever recurring problems and difficulties have arisen. The paper will then consider the coordination of commercial debt rescheduling with the renegotiation of official debt and the appropriate role of the International Monetary Fund. It will conclude with a brief discussion of possible improvements in the present rescheduling process.

The Rescheduling Process

Getting to the table. A recent IMF staff study[2] examined the cases of six IMF members that rescheduled their obligations to commercial banks between 1976 and 1980. It noted that the rescheduling process was generally a long and difficult one, taking from two to five years from the time a debt service problem first emerged until an agreement was actually signed. Generally, negotiations did not begin until one or two years after such signals as the emergence of arrears or the reluctance of banks to roll over maturing credits might have suggested that a rescheduling would be necessary; once begun, the talks themselves took anywhere from 18 months to four years to complete.

One of the difficulties the parties to these negotiations faced surely was the lack of a well established means of resolving their differences. "While the modalities for the restructuring of official debt were fairly well established," comments the IMF study, "the restructuring of debt owed to commercial banks involved, to a large extent, the breaking of new ground." Previous commercial debt reschedulings had concentrated on the restructuring of short-term trade credits, but now the focus was on medium-term syndicated Eurocredits, which brought a host of complications. The hundreds of banks of many different nationalities involved in the various loan syndications had to be contacted. Basic data on how much was owed to whom had to be collected, information that was not always readily available. (One country, which had not kept its records particularly well, had to resort to sending out a questionnaire to its creditors to find out exactly how much it owed.) And in four of the six cases covered in the IMF paper, the negotiations had to be coordinated with parallel discussions with official creditors, who insisted that private and official debt be rescheduled on "comparable terms."

Ultimately, though, despite such obstacles, the negotiations in each of the six cases were successful — at least in the sense of an agreement being reached and signed. (Whether the debtor countries will actually be able to adhere to the terms of these agreements is, of course, a separate question.) The actual hard bargaining was done by a steering committee of a half-dozen or so lead banks on the one side and representatives of the debtor nation (often assisted by investment bankers acting as advisers) on the other. Also playing key roles in the talks, generally as advisers rather than as active participants, were officials of the IMF, and, to a lesser extent, the World Bank. The members of the steering committee were generally chosen from the lead managers and agent banks of the syndicates that had lent money to the country; usually, these banks were the ones with the largest individual exposures. Additionally, steering committee members were chosen on the basis of country representation, so that a bank from each of the major creditor countries was present.

Interbank tension. After the steering committee members were chosen, they faced the sometimes-daunting challenge of forging a common negotiating position for all of the creditor banks. Interbank politics have been one of the more important factors influencing the course of rescheduling negotiations, yet one of the less well understood. One reason for interbank discord, beyond the normal commercial rivalries of this intensely competitive business, has been the fear that debt relief advanced by one creditor might simply be used to pay off someone else, thus leaving the debtor's financial position unchanged. Once a debt-servicing problem develops, creditor banks naturally want to reduce their exposure in the debtor country. They may be willing to go along with efforts to float new loans or reschedule old ones to allow the country more time to work out its problems, but only as part of a joint effort of all the country's creditors. And they are decidedly unwilling to increase their own exposures only to reduce that of someone else. Thus the doctrine of "fair treatment" has emerged as the guiding principle of debt-restructuring negotiations: each bank is expected to participate in debt relief (either new funding or rescheduling) in proportion to its existing exposure. The enforcement of that doctrine, however, is no easy matter. Short-term trade financing is generally not covered, and often banks have sought to reduce their exposure by allowing such credits to expire, thus exacerbating the debtor's foreign exchange shortage and debt-servicing difficulties.

Also contributing to interbank tension have been differences of opinion over the terms that should be offered to the debtor country, with some banks favoring a hardline approach while others adopt a more generous posture, in the belief that the debtor should be given more room to maneuver. In some cases, such divisions follow national lines, with U.S. banks favoring one position and German or French banks another, for example. At other times, however, banks divide up on the basis of size, with large banks adopting one posture and small banks another. Negotiating postures are often influenced by expectations of future business with the debtor country, with banks that hope to do a lot of business taking a more conciliatory attitude than those that do not. Negotiating positions are also influenced by the size of each bank's exposure, reflecting the old adage that a large enough debt turns a creditor into a partner. Further, bank negotiating positions are sometimes determined by the personnel that each chooses to send to the bargaining table with country lending officers — whose basic orientation is toward selling future loans — tending to take a softer line than, say, credit review officers.

A final source of interbank tension is the danger that one or more banks will break rank and strike a separate deal or will attempt to have the debtor nation declared in default and its external assets attached. Because of the cross-default clauses included in most loan syndications, even one such default declaration could set off a chain reaction of defaults, leading to a massive legal tie-up that could take years to unravel. Still, the probability of such a disaster should not be overestimated. Declaring default would only make sense if the initiating bank held deposits from the debtor country sufficient to cover its outstanding loans, but the deposits and other foreign assets of countries in debt service difficulty are generally only a small fraction of their total obligations. In addition, such a bank would be considered a pariah by its peers and could find its access to other international business reduced.

Country advisers. When Indonesia's state-owned oil company Pertamina ran into financial difficulty in 1975, the Indonesian central bank called in three investment banks to assist the troubled company work out its debts with its foreign creditors. The three — Kuhn Loeb of New York, S.G. Warburg of London, and Lazard Freres of Paris — later formed a consortium to provide financial advisory services to other developing countries; their clients have included Zaire, Turkey, Gabon, and Sri Lanka. Similarly, Morgan Grenfell has advised Sudan and Oman.[3]

In past reschedulings, these firms have assisted their clients by pulling together the data on how much they owed and to whom, by advising them on the terms they might reasonably expect from the banks and, in some cases, by actually negotiating on their behalf. But though such services have greased the wheels of the rescheduling process, the investment bankers' role has drawn a good deal of fire from the commercial bankers' side of the table. While applauding the investment firms' assistance in reorganizing and consolidating their clients' debt service accounts (which, in some cases, were in shocking states of disarray) and in toning down the debtors' more unrealistic demands, some commercial bankers fear that, by interposing themselves between debtor and creditor, the investment advisers will inhibit the development of the confidence and trust necessary in such situations. In addition, these bankers believe that the investment firms will attempt to duplicate the terms won for one country for all of their other clients, with the result that rescheduling will become less flexible, more concerned with precedent, more legalistic and more adversarial. Naturally, the investment bankers dispute these contentions, arguing that the debtor countries have every right to expert financial counsel, just as they have to top-flight legal advice.

Relationship to Official Rescheduling

In four of the six cases covered in the IMF study, the debtor nation also negotiated a multilateral rescheduling of official debt under the auspices of the Paris Club. In these cases, creditor governments insisted on the principle of "comparable treatment" of other creditors. Like the banks, they did not want to grant debt relief only to see it used to bail out someone else — particularly when the "someone else" was a private commercial bank that had extended credit presumably in full awareness of the risks of nonpayment. Nonetheless, a comparison of the terms of the private and official reschedulings reveals that the official creditors were somewhat more generous. This primarily reflects the fact that private loans carry variable interest charges at market levels, while rates on official loans are fixed and below-market. However, official creditors were also more willing to reschedule interest in arrears and resume lending once the agreement had been signed. The banks, by contrast, reflecting their quite different motivations for lending, were understandably more reluctant to return to "business as usual" until the debtor's creditworthiness markedly improved.

Role of the IMF

In each of these six cases, the staff of the International Monetary Fund provided technical support to the negotations. The IMF provided the banks with information on the debtor nations' economic outlook and payment prospects; this was done in an informal manner, either by telephone or in meetings between bank officials and Fund personnel. The IMF also aided the countries involved in preparing for their negotiations with the banks, particularly in those cases where the lack of reliable statistical data was an important problem. In four of the cases, IMF staff members sat in on discussions between the banks and the countries, and on one occasion, when talks were at an impasse, the IMF played a more active role by trying to mediate the dispute.

In each instance, the banks suggested that the debtor country negotiate an upper credit tranche program with the IMF. Such programs were important to the banks not so much for the hard currency provided but as signs that the countries had embarked on the road to recovery. In five out of the six cases, such a program was in place at the time the rescheduling agreement was signed, with the disbursement of new funds or the consolidation of existing obligations being made contingent upon the country's compliance with the terms of its IMF arrangement.

The flow of information between the IMF and the banks has not been strictly one-way, however, since the IMF needs to know the magnitude of expected private capital flows, including debt relief, in devising a realistic adjustment program for countries with payments problems. In some cases, the IMF has even offered its suggestions to the banks on what would be an appropriate amount of debt relief, in one case playing an "active role" (the words are from the IMF staff study) in assuring that the banks in fact provided the targeted level of assistance.

The reschedulings of Peru's and Nicaragua's debts illustrate both the importance and limits of the IMF's role. In 1976, before Peru had begun talks with the IMF, the banks agreed to a $400 million balance of payments support loan conditional upon the government's compliance with its announced stabilization program. That program had been drawn up at the request of the banks and strongly resembled standard IMF orthodoxy, although the IMF was not involved in either its design or its execution. The banks soon found, however, that they were unable to monitor the program in the manner of the IMF; they had neither the expertise nor the standing to do so. Peru's performance quickly diverged from that promised by the program, and the banks were forced to cancel the second $200 million installment of the loan. At that point, the IMF was called in.

The lack of IMF participation in the Nicaragua talks reflected the unusual political circumstances surrounding those negotiations, which help, in part, to explain the unusually favorable terms that resulted. The IMF had begun talks with the Somoza government on a stabilization program in 1978; the two sides reached agreement, in fact, only a few weeks before that regime fell in 1979. After their accession to power, the Sandinistas renounced the agreement and would have nothing further to do with the Fund, despite the devastated state of the Nicaraguan economy and its need for foreign exchange. Nicaragua was able to succeed in shutting out the IMF, however, only because of the donations, soft loans, and central bank deposits it received from other governments and multilateral institutions — the World Bank and Inter-American Development Bank in particular. With its foreign exchange coffers replenished, Nicaragua was able to avoid the need for an IMF agreement and was in a stronger bargaining position with the banks. The moral and financial support it received, however, was coupled with pressure to reach a rescheduling agreement. In this way, the "good offices" role normally performed by the IMF was filled instead by its sister institutions.

The absence of the IMF from the Polish rescheduling underscores the need for a process flexible enough to handle situations involving non-IMF members. Unfortunately, the institutions that stepped into the breach in Nicaragua were unable to do the same in Poland, and no other intermediaries have yet appeared.

Alternatives to the Present Process

Those who are concerned over the adequacy of the present system (or lack thereof) often express their preference for a more formalized, institutionalized process, perhaps under IMF auspicies. The Fund is probably the most logical institutional home for such a mechanism, in light of its pivotal role in balance of payment adjustment cases. However, if a commercial bank rescheduling mechanism were to be set up under the IMF umbrella, several important obstacles would have to be overcome. Not the least of these are the somewhat skeptical attitudes toward the IMF of both parties to rescheduling negotiations. Debtor countries may view the Fund as a collection agent for the commercial banks, while many bankers, for their part, believe that the Fund is ultimately answerable to its member governments and is thus biased toward the interests of the debtor. In any event, private creditors will probably be wary of surrendering any of their legal claims to a supranational arbitration body, however (and wherever) institutionalized.

Another possible institution that could aid in rescheduling negotiations is the suggested International Banking Consultative Group (described on pp. 33 through 35).

Whatever procedures for rescheduling are ultimately decided upon, or simply evolve, it may be useful to anticipate them at the time loans are originally extended by incorporating the appropriate clauses in the loan documentation. Such language would have the advantage of specifying in advance the conditions under which rescheduling would be appropriate and how the talks should be conducted, thereby reducing the costly delays usually associated with getting the negotiations underway. The other side of such specificity, however, is the loss of the flexibility of the current process. In addition, such clauses would of course not be binding upon the parties to other loan syndications not including them; they might, therefore, be rendered inoperative if these other creditors did not agree to them.

Conclusion

Procedural reforms will not, of course, avert the difficult financial problems which lead to reschedulings. But the prospect of such problems underscores the importance of procedures intended to avoid their less desirable effects. The likelihood of continued large payments deficits and the possibility of debt service problems in major debtor countries suggest that rescheduling will be a recurring feature of the international financial system of the 1980s. If so, participants in that system may wish to alter the process of rescheduling so as to improve its probability of success, either by the proposals offered here or by some other, as yet unsuggested, reforms. Reforms of the rescheduling process should thus be a matter for active consideration.

[1] Occasionally, these governments met in the Hague or London; sometimes they styled themselves as OECD or IBRD consortia. Despite the variance in place and name, however, their basic structure and function was analogous to that of the Paris Club.

[2] Bahram Nowzad, Richard C. Williams, et al., "External Indebtedness of Developing Countries," Occasional Paper No. 3, International Monetary Fund, Washington, D.C., May 1981. This note draws heavily on information contained in the IMF study and two other recent papers (A Porzecanski, "The Assessment of Country Risk: Lessons from the Latin American Experience," in Garcia-Zamor and Sutin, eds., *Financing Development in Latin America* (NY: Praeger, 1980); and L Brainard and T. Trebat, "The Role of Commercial Banks in Balance of Payment Crisis — The Cases of Peru and Poland," presented to the International Conference on Multinational Corporations in Latin America and Eastern Europe, March, 1981) as well as the case studies of Nicaragua and Turkey presented to the Study Group and recent material from the press and trade journals.

[3] See Anthony Sampson, *The Money Lenders* (New York: Viking Press, 1982), pp. 218—220.

APPENDIX C

Trends in Eurocurrency Credit Participation 1972-1980

Diane Page and Walter D. Rogers

The burgeoning Eurocurrency credit market exceeded $70 billion in publicized volume in 1980, compared to $9 billion in 1972. Today, the bulk of publicized Eurocurrency lending is done by bank syndicates rather than individual institutions. Although the financial press annually allocates syndicated Euroloan volume among managing institutions, identifying the world's top Eurolenders, no one has documented the steady influx of new loan participants into the Eurocurrency credit market or comprehensively considered the changing nationality of participants over time. Using World Bank data, Office of the Comptroller of the Currency staff were able to examine these non-volume indicators of the increasing breadth of the publicized Eurocurrency credit market.[1]

Analysis of the World Bank data shows that a relatively constant average of 66 independent financial institutions became first-time entrants into the Eurocurrency credit market each year between 1973 and 1980. By 1980, nearly 400 independent financial institutions were active in the market. In the earlier years, the new entrants were largely European and North American banks and international consortium banks. More recently, Latin American, Middle Eastern and Asian institutions have entered the market in greater numbers. Further findings from the World Bank data reinforce the well-documented expansion of Middle Eastern financial institutions into Eurocurrency lending. For example, in terms of number of participating institutions, Middle Eastern institutions have increased their presence in the market from less than one percent in 1972 to an eight percent share of the total in 1980. However, in every year, European and U.S. institutions ac-

---

Diane Page and Walter D. Rogers are Financial Analysts of the Strategic Analysis Division of the Office of the Comptroller of the Currency. C. Stewart Goddin, Judith A. Walter and Steven J. Weiss made valuable comments on earlier drafts of this paper. Vivian L. Oyola did the necessary computer programming. The views expressed in this paper are the authors' and do not necessarily represent the views of the Office of the Comptroller of the Currency.

count for the bulk of total participating institutions as well as total loan participations.

Introduction

Analysis in this paper is restricted to publicized Eurocurrency credits. It examines financial institutions which were Eurocurrency loan participants between 1972 and 1980, considering their nationality, entry into the Eurocurrency market, and number of yearly loan participations.

Eurocurrency credits are loans and credit lines denominated in a currency other than that of the country in which the lending institution is located. Eurocurrency credits first appeared in the 1960s. At that time, they were almost exclusively fixed-rate loans to corporate borrowers underwritten by specialized investment banks, notably the British merchant banks, which later sold participations to other banks. The Eurocurrency credit market began to take on its present characteristics in the early 1970s. Loans became floating rate instruments. Nations began to finance balance of trade deficits through Eurocurrency borrowings. And the world's large international commercial banks began managing large Eurocurrency credits through syndications. Syndication of credits reduced risk for the underwriters and brought together the large resources necessary to finance sovereign debt. With successive oil price increases in 1973 and 1974, the oil-producing nations developed trade surpluses while non-oil-producing less-developed countries faced growing deficits. The Eurocurrency credit market began to serve a vital function as a recycling mechanism, moving surplus capital from the oil-producers to the non oil-producing nations. Publicized Eurocurrency credits reached a volume of $70.4 billion in 1980, according to World Bank data. Publicized credits, which are medium- to long-term and usually syndicated, represent only a portion of international borrowing. It has been estimated that one-half of Eurocurrency bank lending is short term, unpublicized lending used for private trade and international business financing.[2] International and foreign bond issues are another vehicle for international borrowing, and accounted for $41.8 billion in 1980.[3]

Description of the Data

Data collected by the World Bank cover publicized borrowing in international capital markets in the form of Eurocurrency credits between 1972 and 1981.[4] Notice of Eurocurrency credits appears in a published announcement known as a tombstone. The tombstone generally contains the name of the borrower, the amount of the credit, and the names of the financial institutions which participate in the loan. Often, but not always, Eurocurrency credits are led by a single large institution. Smaller volume credits are less likely to have a lead manager, while some loans have two or more co-lead managers. The lead manager receives a mandate from the prospective borrower to raise funds and seeks to put together a managing group.

The lead manager typically underwrites the entire amount of the credit, making a commitment to provide the funds before arranging the syndication. On the tombstone, institutions are usually listed in order of the size of the participation they take in the loan. As a rule, the lead manager is listed first, followed by managers, co-managers, and participants, which take successively smaller portions of the loan. When institutions are listed in alphabetical order, this generally indicates that each participant has taken an equal participation. Sometimes institutions are listed in alphabetical order within manager, co-manager and participant sub-groups.

Table I

Eurocurrency Credit Aggregates 1972-1980

Year	Loan Volume ($ billions)	Total # Loans	Total # Participations	% Loans with Unnamed Participants	% Participations By Unnamed Participants
1972	8.8	258	415	1	1
1973	20.8	402	725	1	1
1974	28.5	474	1027	1	1
1975	20.6	418	1482	5	6
1976	28.7	430	1827	8	9
1977	34.2	489	2360	10	10
1978	73.7	786	3781	15	20
1979	70.2	813	4329	16	22
1980	70.4	797	4913	18	24

Source: World Bank data.

* A small percentage of participants are listed as "syndicates" and thus actually represent more than one institution.

Computerized World Bank data identify by name a maximum of ten participants per individual Eurocurrency credit in order of their appearance on the tombstone. When a loan has more than ten participants, nine participants are identified by name and the number of additional, unnamed participants is indicated. Since these additional participants are not identified, there is no way to ascertain how many individual institutions participated in all loans in each year. However, it is possible to aggregate the total number of named and unnamed *participations* for all loans in each year, and likewise to determine how many loans had unnamed (more than ten) participants. As shown in Table I, an increasingly significant proportion of total loan participations, 24 percent by 1980, have been taken over time by participants not identified by name in the World Bank data. The number of loans with unnamed participants increases to 18 percent of total loans by 1980. The reader should bear in mind that, in most of the following discussions of participant nationality, new entry and loan participations, only named participants, those who took the first nine or ten listed positions on each loan, are considered. It was not possible to identify the unnamed participants or to draw any conclusions about their entry trends or nationality patterns.

In the following analysis, information has been provided on those institutions appearing as first listed participant for each loan in the World Bank data, i.e., institutions listed first on the loan tombstones. Although this information provides some indication of the nationality distribution of lead managers, it should be interpreted with caution. As explained above, lead managers usually appear first on the publicized loan notices. However, since some credits have no lead manager, some credits have a number of co-lead managers, and some tombstones list all participants alphabetically, first participant position in the World Bank data is not a perfect proxy for lead manager. (World Bank staff estimate that about 20 percent of the Eurocurrency credit tombstones list participants alphabetically.)

Nationality of the named participants is not included in World Bank data and was determined using a variety of almanacs, yearbooks and other reference sources. Institutions were grouped by nationality of ownership rather than country of charter; Euroloan activity of branch offices or subsidiary companies has been credited to the head office or parent institution. For example, Deutsche Bank AG, Deutsche Bank AG (London), and Deutsche Bank Cie. Fin. Luxembourg were all considered part of a single German financial institution when determining the number of German Euroloan participants, German entry into the market, and the number of German loan participations.

Results

Between 1972 and 1980, the number of publicized Eurocurrency credits tripled from 258 to 797 and their combined volume increased from $8.8 to $70.4 billion, according to World Bank data (see Table I).[5] The following analysis is based on a direct comparison between Eurocurrency credit activity in 1972 and 1980, since changes between 1972 and 1980 reflect trends which characterize the intervening years. However, the figures are also affected by specific factors such as the slowdown in U.S. Eurolending dating from 1979 and government restrictions on foreign lending of Japanese banks in 1980. (See Appendix tables.)

Number of lenders

The number of named loan *participants*, consolidated into parent institutions, nearly tripled from 133 to 386 between 1972 and 1980. Figure I shows a geographic breakdown of these institutions in 1972 and 1980.[6] (Consortium banks were placed in the Asian, European and Middle Eastern categories when their owning institutions were identified as all Asian, all European or all Middle Eastern.) The absolute number of managers in all geographic categories increased, but relative shares of the total changed over time. The predominance of European institutions, well over one third of the total in both years, is evident, as is the growing importance of the Middle Eastern institutions, which represented less than one percent of the total share in 1972 and 8 percent in 1980. The share of U.S. and Canadian institutions, on the other hand, dropped by ten percent of the total, while the share of Asian institutions dropped by five percent of the total.

New entry

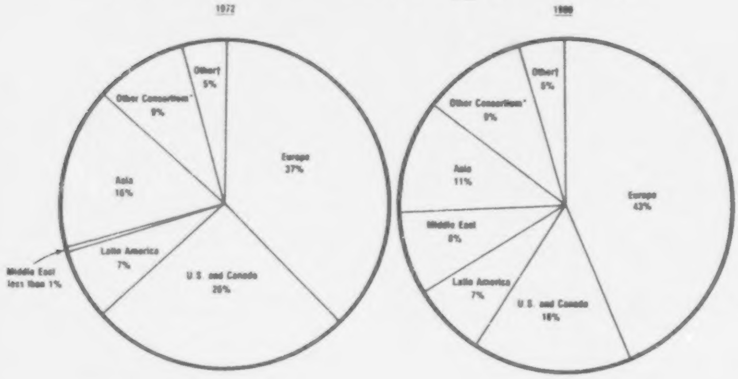
Between 1973 and 1980, 526 parent institutions which had not participated in any previous year for which data are available entered the Eurocurrency credit market. The number of new entrants is relatively constant, averaging 66 per year (Figure II).

Figure I

Nationality of Parent Financial Institutions Participating in the Publicized Eurocurrency Credit Market

1972 & 1980

(First through Tenth Listed Participants Only)



Source: World Bank data

* Consortium banks which did not fit in any regional category, such as UBAF, which is owned by European and Middle Eastern institutions.

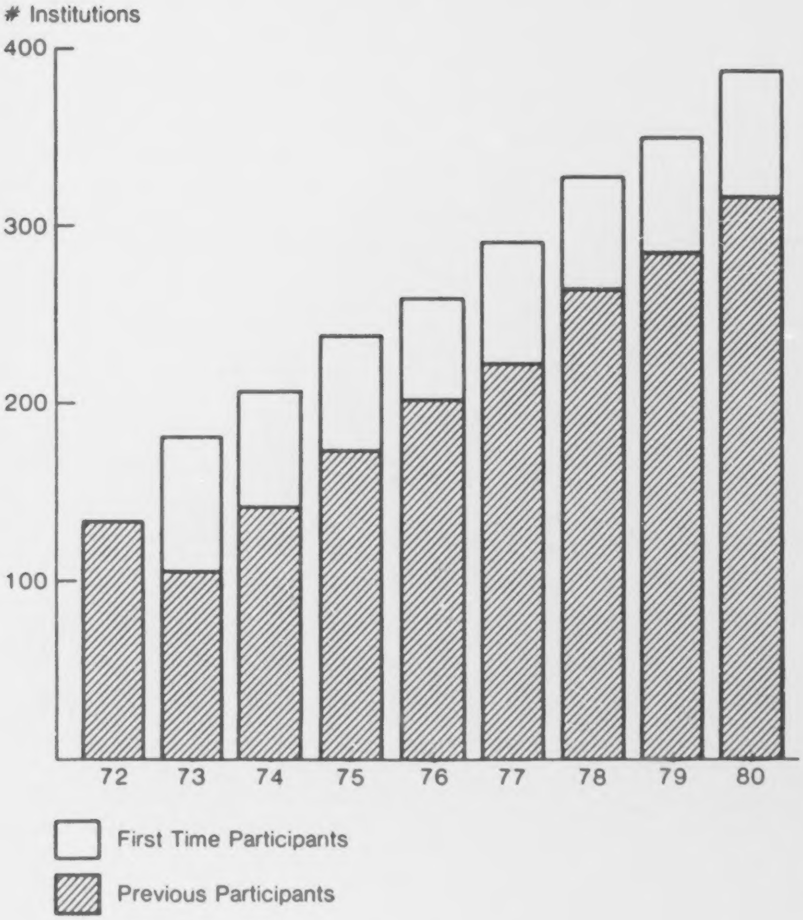
† Africa, Oceania and a very small percentage (less than 1 percent) of institutions which could not be identified by nationality.

Financial Institutions
Participating in the Euroloan Market
1972-1980
(First through Tenth Listed Participants Only)

	72	73	74	75	76	77	78	79	80
Austria	0	0	4	4	4	11	5	7	14
Belgium	4	3	3	5	4	3	3	4	4
Luxembourg	3	3	3	4	5	7	11	7	7
Fed. Rep. of Germany	5	7	10	13	13	17	17	22	21
France	9	15	14	16	15	17	17	22	19
Italy	3	5	6	5	8	9	18	12	15
Netherlands	0	1	3	4	5	5	5	6	5
Spain/Portugal	2	5	9	13	14	13	11	19	22
Switzerland	2	2	4	4	9	9	8	9	11
United Kingdom	18	24	20	18	19	18	18	19	18
Other, W. Europe	1	9	9	18	12	14	14	16	17
E. Europe	1	2	3	3	2	1	1	2	5
Total	48	76	88	107	110	124	128	145	158
Canada	3	4	7	9	7	9	9	10	9
USA	31	40	41	46	46	43	49	50	54
Total	34	44	48	55	53	52	58	60	63
Mexico/Central/S. Amer.	6	3	5	6	5	8	8	12	23
Caribbean	3	2	5	3	4	3	2	4	3
Middle East	1	2	3	6	11	17	25	23	25
Africa	1	0	1	1	1	2	1	2	3
Japan	17	21	17	7	13	18	24	24	24
Other Asia	5	2	4	5	4	9	11	16	19
Total	22	23	21	12	17	27	35	40	43
Oceania	2	0	1	2	1	1	3	5	8
Consortia	12	22	30	36	48	49	60	51	51
of which European	1	4	4	5	6	7	7	8	9
Arab	0	0	1	2	3	5	9	6	6
Asian	0	1	1	1	1	0	0	1	0
Other	11	17	24	28	38	37	44	36	36
Unidentified	4	6	5	7	6	5	7	5	9
GRAND TOTAL	133	178	207	235	256	288	327	347	386

Figure II

First-Time and Previous Participants in the Publicized Eurocurrency Credit Market*
1972-1980



* Refers to first-time entry since 1972; data not available for previous years.

Financial Institutions Entering the Euroloan Market for the First Time*
1973-1980
(First through Tenth Listed Participants Only)

	73	74	75	76	77	78	79	80
Austria	0	4	1	1	5	1	0	5
Belgium	0	0	1	1	0	0	1	0
Luxembourg	0	0	2	3	3	3	0	2
Fed. Rep. of Germany	2	5	4	1	4	1	4	2
France	7	2	4	2	3	0	6	1
Italy	2	1	1	2	5	5	2	1
Netherlands	1	2	1	2	2	1	0	0
Spain/Portugal	3	4	5	2	1	1	6	7
Switzerland	1	2	0	5	3	1	3	2
United Kingdom	9	2	1	1	0	1	0	1
Other, W. Europe	8	3	9	3	1	0	0	1
E. Europe	1	1	1	0	0	0	0	3
Total	34	26	30	23	27	14	22	25
Canada	1	3	3	1	1	0	1	0
USA	13	9	10	7	5	7	6	10
Total	14	12	13	8	6	7	7	10
Mexico/Central/S. Amer.	2	2	0	0	3	3	3	10
Caribbean	0	2	0	0	2	0	3	1
Middle East	2	3	2	6	9	11	7	3
Africa	0	0	0	1	1	0	2	1
Japan	4	1	0	1	2	4	1	1
Other Asia	2	1	2	1	6	4	5	10
Total	6	2	2	2	8	8	6	11
Oceania	0	0	1	0	0	1	4	2
Consortia	13	14	13	14	7	15	6	5
of which European	3	0	1	2	1	0	1	0
Arab	0	1	2	1	1	4	0	1
Asian	1	1	1	0	0	0	0	0
Other	9	12	9	11	5	11	5	4
Unidentified	4	4	3	2	3	4	4	5
GRAND TOTAL	75	65	64	56	66	63	64	73

* Refers to first-time entry since 1972; data for previous years not available.

Table II

Nationality of Parent Financial Institutions Entering the Publicized Eurocurrency Credit Market for the First Time*

1973-1980

	Nationality						
Year	Eur.	N. Amer.	Latin Amer.	Asian	M. East	Other Consortium	Other
1973	37	14	2	2	7	9	4
1974	26	12	4	4	3	12	4
1975	31	13	0	4	3	9	4
1976	25	8	0	7	2	11	3
1977	28	6	5	10	8	5	4
1978	14	7	3	15	8	11	5
1979	23	7	6	7	6	5	10
1980	25	10	11	4	11	4	8
TOTAL	209	77	31	53	48	66	42

Source: World Bank data

* Refers to first-time entry since 1972; data not available for previous years.

Table II shows the nationalities of the new entrants. European, North American and Other Consortium institutions (consortium banks whose owners did not fit nearty into a regional category) demonstrate a declining rate of new entry. This is not surprising since institutions from countries with the most internationally active and highly developed banking systems entered the Eurocurrency credit market first. Also, consortium banks were established early as a means of access to the market. Latin American, Asian and Middle Eastern institutions exhibit increasing rates of new entry over time. (Asian rates would be more pronounced if not for the effect of periodic Japanese government restrictions on foreign lending, which caused Japanese entry and participation in the syndicated Euroloan market to fluctuate. Other Asian nations demonstrate steadily increasing participation.) While European institutions continue to dominate the new entry table in terms of sheer numbers, the increasing entry of institutions from other regions indicates the growing breadth of the Eurocurrency credit market.

Number of Loan participations

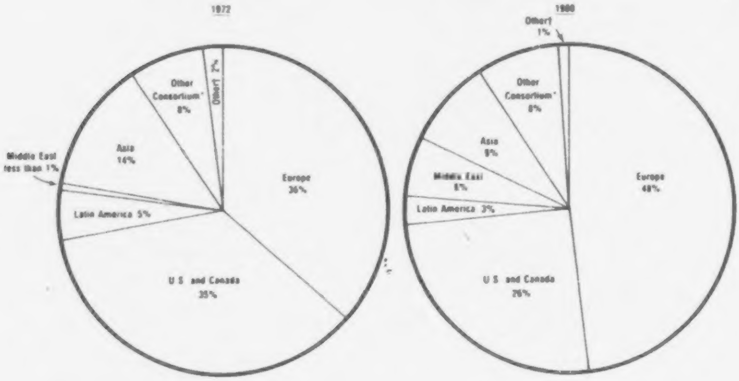
Total yearly loan *participations* by all institutions provide a measure of Eurocurrency credit market size distinct from dollar volume measures. The number of participations by both named and unnamed participants grew from 415 to 4,913 between 1972 and 1980, a twelvefold increase. Participations by named participants, which grew from 412 to 3,723 in that time period, are categorized by nationality in Figure III. In terms of loan participations, European institutions increased their share from just over one third to almost half the yearly total. Again Middle Eastern growth is notable, from a less than one percent to a six percent share. Both the North American and Asian shares declined, by ten percent and five percent of the total respectively.

Figure III

Publicized Eurocurrency Credit Market Participations by Nationality of Participant

1972 & 1980

(First through Tenth Listed Participations Only)



Source: World Bank data

* Consortium banks which did not fit in any regional category, such as UBAF, which is owned by European and Middle Eastern institutions.

† Africa, Oceania and a very small percentage (less than 1 percent) of institutions which could not be identified by nationality.

First listed participants

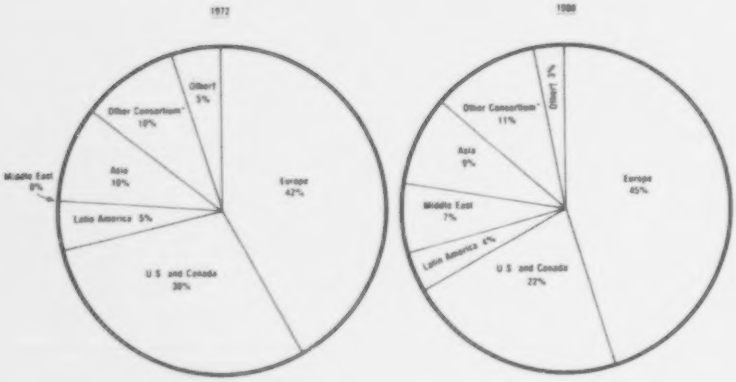
World Bank's first listed participants can be used as a proxy, albeit an imperfect one, for Eurocurrency credit lead managers. It is evident that changes in national shares of total first listed participants are consistent with other share changes described in previous sections. Figure IV illustrates that European institutions account for almost half of total first participants positions in 1972 and 1980. North American institutions moved from holding first participant position in almost a third of all Eurocurrency credits to a 22 percent share in the same time period. Asian institutions maintained a stable first participant share of approximately ten percent, while Middle Eastern institutions, which appeared in *no* first participant positions in 1972, had a seven percent share in 1980.

Euroloan Participations by Nationality of Participant
1972-1980
(First through Tenth Listed Participants Only)

	72	73	74	75	76	77	78	79	80
Austria	0	0	5	16	7	42	15	31	41
Belgium	12	6	17	28	12	35	49	106	110
Luxembourg	8	9	15	11	27	31	51	70	45
Fed. Rep. of Germany	11	15	59	115	108	219	254	300	254
France	27	67	125	100	92	103	162	223	395
Italy	9	25	22	7	11	15	39	55	98
Netherlands	0	2	8	27	28	45	81	78	67
Spain/Portugal	5	7	29	32	36	41	38	77	100
Switzerland	2	4	9	20	32	47	63	74	76
United Kingdom	65	106	113	127	156	207	280	357	416
Other, W. Europe	2	15	16	35	48	47	46	71	81
E. Europe	3	4	7	11	6	1	2	6	17
Total	144	260	425	529	563	833	1080	1448	1700
Canada	10	24	44	117	121	153	261	284	301
USA	136	239	346	503	653	658	749	613	657
Total	146	263	390	620	774	811	1010	897	958
Mexico/Central/S. Amer.	10	3	8	29	19	22	29	60	95
Caribbean	9	10	12	3	5	3	2	4	9
Middle East	1	5	4	19	19	48	106	80	113
Africa	1	0	1	1	3	2	2	2	5
Japan	51	99	37	14	32	97	355	466	258
Other Asia	6	4	7	14	11	24	36	42	80
Total	57	103	44	28	43	121	391	508	338
Oceania	2	0	2	3	1	1	5	5	25
Consortia	36	70	128	161	233	284	373	386	467
of which European	4	9	25	14	19	37	45	55	72
Arab	0	0	1	4	8	12	50	54	92
Asian	0	1	1	1	1	0	0	2	0
Other	32	60	101	142	205	235	278	275	303
Unidentified	6	6	9	15	9	6	9	9	13
GRAND TOTAL	412	720	1023	1408	1669	2131	3007	3399	3723

Figure IV

Total Publicized Eurocurrency Credits by Nationality of First-Listed Participants 1972 & 1980



Total = 230**   Total = 798**

Source: World Bank data

* Consortium banks which did not fit in any regional category, such as UBAF, which is owned by European and Middle Eastern institutions.

† Africa, Oceania and a very small percentage (less than 1 percent) of institutions which could not be identified by nationality.

** Totals do not match loan totals in Table I due to omissions in World Bank data.

Number of Euroloans by Nationality of First-Listed Participant[1]
1972-1980

	72	73	74	75	76	77	78	79	80
Austria	0	0	3	3	1	3	3	2	6
Belgium	6	2	3	7	1	7	7	13	19
Luxembourg	4	4	3	3	7	10	7	14	8
Fed. Rep. of Germany	4	7	20	19	23	39	67	55	40
France	19	34	58	32	23	19	35	45	70
Italy	2	7	7	1	2	4	15	8	9
Netherlands	0	1	2	6	8	6	17	8	12
Spain	1	1	2	5	6	10	8	21	27
Switzerland	1	1	4	4	2	1	10	21	22
United Kingdom	45	83	73	50	46	50	73	100	90
Other, W. Europe	0	2	3	7	11	18	18	19	19
E. Europe	3	0	0	3	0	0	0	0	0
Total	85	142	178	140	130	167	260	306	322
Canada	6	12	7	14	10	14	35	55	45
USA	87	145	179	181	190	194	286	242	231
Total	93	157	186	195	200	208	321	297	276
Mexico/Central/S. Amer.	1	0	3	6	4	2	12	11	15
Caribbean	7	10	6	1	2	2	1	1	1
Middle East	0	3	3	1	2	6	34	17	28
Africa	0	0	0	0	0	0	1	0	0
Japan	11	33	12	2	5	12	45	66	24
Other Asia	1	2	3	8	5	4	4	2	11
Total	12	35	15	10	10	16	49	68	35
Oceania	1	0	1	1	0	0	2	2	5
Consortia	26	31	59	51	79	84	96	105	114
of which European	1	1	3	3	8	11	11	15	21
Arab	0	0	1	2	4	1	16	10	14
Asian	0	0	0	1	1	0	0	0	0
Other	25	30	55	45	66	72	69	80	79
Unidentified	5	1	4	5	0	4	0	3	2
GRAND TOTAL[2]	230	379	455	410	427	489	776	810	798

[1] First-listed participant in World Bank data usually refers to the lead manager.

[2] Totals do not equal Eurocurrency loan totals found in Table I in the text due to omissions in World Bank data.

Conclusion

World Bank data, although identifying only ten participants per Euroloan, can be used to provide some information on the pace of new entry into the Eurocurrency credit market and patterns of changing nationality among lending institutions. Conclusions drawn from the data become less certain in later years, because of the significant increase in the number of unidentified participants listed beyond position ten in individual loans.

The picture resulting from a study of the data is one of a growing and broadening syndicated Eurocurrency credit market between 1972 and 1980. The growth in number and volume of loans has been accompanied by a growth in the number of institutions participating in those loans. Growth in total number of loan participations has outstripped the growth rate in number of loans; this is another indicator of increased market breadth. A steady average of 66 new institutions has entered the market yearly.

Institutions headquartered in Europe and North America, active in the Euroloan market in earlier years by virtue of their well developed international banking presence, still accounted for the bulk of yearly participations, lending institutions and first listed participants (a proxy for lead manager) in 1980. However, new lender institutions from these countries are entering the publicized Eurocurrency credit market at a declining rate. In recent years, increasing numbers of new entrants are from Latin America, Asia and the Middle East. Institutions from the Middle East as a whole have increased their share of yearly loan participations, loan leadership and representation among lending institutions notably, from less than one percent of the total in 1972 to six to eight percent in 1980. This increased share has been balanced in part by the declining share of North American institutions.

Endnotes

[1] World Bank data are limited, identifying a maximum of ten participant institutions per individual loan. This limitation becomes more important over time. See Table I for the number of loans with unidentified (greater than ten) participants on a yearly basis.

[2] Laurie Goodman, "The Pricing of Syndicated Eurocurrency Credits," Federal Reserve Bank of New York *Quarterly Bulletin*, Summer 1980, p 40.

[3] Morgan Guaranty Trust Company, *World Financial Markets*.

[4] The World Bank stopped collecting this type of data as of the second quarter of 1981, since it is now available from several other sources such as Caploan and the Euromoney syndication service.

[5] Volume of publicized Eurocurrency credits is available from many other sources including Morgan Guaranty Trust Company, the OECD and Caploan. Reported numbers differ due to differences in timing, coverage, etc. Compare, for example, the World Bank figures with those found in Morgan Guaranty's *World Financial Markets*: $6.9 billion in 1972 and $76.8 billion in 1980.

[6] Tables from which these charts are derived may be found in the following these notes.

APPENDIX D

Overview of National Regulatory Arrangements

Richard Dale

National authorities use a variety of approaches and controls to foster bank safety and soundness and to maintain confidence in the banking system as a whole. The techniques employed may be broadly categorized into preventive regulation designed to limit risks incurred by banks; schemes which offer protection to depositors in the event of bank failure; and support provided by national monetary authorities to banks experiencing liquidity difficulties (the lender of last resort function).

Preventive Regulation

Among measures aimed at controlling the levels of risk incurred by banks are those concerned with market entry, capital and liquidity adequacy, permissible business activities, foreign currency exposure, concentration of loans and country risk exposure.

In virtually all national banking systems regulation begins at the market entry stage. Before they can be authorized, banks must satisfy various requirements which typically include a reputable management and some minimum amount of subscribed capital, the capital requirement, where formalized, varying from the equivalent of US$1m (Switzerland) to nearly US$10m (United Kingdom). For both competitive and prudential reasons branches of foreign banks must generally possess a specified amount of endowment capital, although the United Kingdom imposes no such requirement while Canada limits all foreign-owned banks to the subsidiary form. Several countries apply an economic need criterion and in such cases market entry may be restricted or (as in Italy) suspended altogether with a view to curbing excessive and destabilizing competition.

In addition to a minimum capital requirement, banks are generally

---

Richard Dale is currently a Rockefeller Foundation International Relations Fellow based at the Brookings Institution.

required to maintain an appropriate relationship between capital on the one hand and total assets, risk assets or liabilities on the other. However, some countries (Italy, Canada) do not formally regulate capital adequacy, others (including the United States) make an essentially judgmental assessment while most European countries apply solvency ratios of varying complexity which incorporate different weightings for different categories of risk asset. In this last case, the weightings applied to similar categories of asset may vary. For instance, whereas Switzerland applies a premium weighting to all foreign assets, the Netherlands accords a preferential zero weighting to loans to foreign governments. In addition, one country (Belgium) applies a solvency ratio which discriminates in favor of larger banks on the grounds that small banks are more risky.

Definitions of capital differ, particularly in the treatment of subordinated debt. A few countries such as West Germany exclude subordinated debt altogether, others include it up to a limit that varies between 10 per cent and 50 per cent of total capital, while the United States federal supervisory agencies have not agreed on a common approach to this question. Because of the variety of methods used in capital adequacy assessment, it is not possible to make direct comparisons between requirements in different countries.

Capital adequacy may or may not be assessed on a world-wide consolidated basis and branches of foreign banks may or may not be separately assessed. However, the general trend is towards consolidation as indicated by recent moves in this direction by Switzerland and Germany. Even so, the treatment for consolidation purposes of non-wholly owned subsidiaries and minority interests may differ.

As with capital adequacy, approaches to the measurement and control of liquidity vary considerably. Some countries (including the United States and Canada) choose not to lay down formal prudential liquidity requirements while others (notably the Netherlands, Germany and Switzerland) apply a number of ratios designed to limit the extent of maturity mismatching in banks' balance sheets. In a few cases (for instance France and Italy) banks which accept short-term deposits are regulated separately from those engaging in longer term banking business, and special limits may be placed on their term lending. Where regulation is formalized, distinctions may or may not be drawn on the assets side between primary, secondary and other classes of liquidity and on the liabilities side between interest-sensitive money market funds and retail deposits. In addition, the treatment of foreign currency items varies, with France, for instance, requiring separate calculations for local and foreign currency liquidity. Although most national schemes seek to classify liabilities both by maturity and volatility, with a view to determining the extent to which funds may prudently be used as a basis for maturity transformation, direct comparisons of permissible transformation are not possible because of the variety of assessment methods and other institutional differences.

In general, liquidity regulation does not take account of undue deposit concentrations, although the Netherlands imposes extra liquidity requirements on "large item" liabilities. Some countries (notably the United States) assess liquidity on a world-wide consolidated basis, others (such as France) confine their regular assessments to banks' domestic offices, while branches of foreign banks may or may not be included in the assessment process.

Typically, banks are limited as to the kinds of business they can engage in although such restrictions may in part reflect non-prudential concerns such as potential conflicts of interest or undue concentrations of economic power. There is no generally accepted distinction between banking and non-banking business and restrictions in this area not only differ in scope but are also imposed in a number of different ways. Several countries (notably the United States, Canada and France) prohibit the mixing of banking and non-banking business within the bank entity while permitting participation in at least some kinds of non-banking activity through bank holding companies, subsidiaries and/or minority interests. Other countries (such as the Netherlands) permit the bank entity itself to engage directly in non-banking business but limit the scope for investment in non-bank companies. A third approach (illustrated by France) permits a wider range of activities to be undertaken by a special category of separately regulated universal banks. Finally, some countries (such as the United Kingdom, Switzerland and Germany) impose few restrictions on the kinds of business banks may engage in, whether directly or through affiliates. In the case of international operations, restrictions may be relaxed so as to enable foreign branches of domestic banks to compete more equally in their country of residence with local banks.

In the area of foreign exchange risk, all countries monitor banks' exposure and seek to ensure adequate internal control procedures, but there are marked differences in regulatory procedures. Some countries (including the United States, Canada and France) prefer to avoid general limits or norms, others (such as the Netherlands and Switzerland) apply incremental capital requirements to uncovered positions, while a third group (including Germany and the United Kingdom) imposes guidelines or formal limits on aggregate, and in some cases, individual foreign currency positions. Where limits are indicated, they are generally stated as a percentage of bank capital. The monitoring and control of foreign currency exposure may (as in the United States) embrace foreign branches and subsidiaries of domestic banks, but in other cases, foreign subsidiaries are excluded while the treatment of local branches of foreign banks also varies.

Most supervisory authorities seek to limit risk concentrations by imposing formal or informal limits on each banks' loans to a single borrower. Stated as a percentage of the lending bank's capital, the limits vary between 100 per cent (Italy) and 10 per cent (the United States), subject to varying definitions of capital for this purpose. In general these lending ceilings are not directly applicable to country risk exposure involving several borrowing entities from the same country, although the US statutory 10 per cent limit may be applied in this way where there is a common source of repayment.

On the other hand, most countries do attempt to measure and monitor their banks' country risk exposure. Sometimes (as in the United States and United Kingdom) this is done on the basis of world-wide consolidated data, embracing cross-border and non-local currency loans to foreign borrowers adjusted for third party guarantees. In other cases (for instance Italy, France and Germany) exposure data is not fully consolidated while risk transfers via third party guarantees are generally ignored. Several countries (notably Germany, Switzerland and Belgium) require banks to report their methods of country risk evaluation, while the United States categorizes countries into three risk classes in order to assess the extent of banks exposure to potential defaults. Such exceptions apart, regulators do not generally seek to form an independent judgment as to individual countries' financial prospects. Nor do regulators impose an absolute limit on total country risk exposure, although Switzerland applies a special premium capital requirement to banks' foreign assets.

The role of bank inspections in the regulatory process varies considerably from country to country. At one end of the spectrum is the United States where regular on-site examinations lie at the heart of the supervisory system and whose examiners are required to provide a composite rating of each bank on a standardized basis. At the other end of the spectrum is the United Kingdom which eschews bank inspections in favor of a surveillance system based on interviews with management backed by extensive reported data. Routine on-site bank examinations, where they occur, may be conducted by the supervisory authorities' own inspectorate (as in the United States, Canada, Italy and France), special auditors appointed and paid for by the authorities (Belgium), auditors licensed by the authorities and subject to special statutory duties (Switzerland) or general auditors (Germany). Examinations may take place annually (as in Canada), every 3-4 years (Italy) or at intervals varying between 1 to 2 and 10 years depending on the size and standing of the institution concerned (France). Several countries confine on-site examinations to banks' head offices while few (a major exception being the United States) conduct routine inspections of banks' foreign establishments.

Deposit Insurance

Most countries either have or are in the process of introducing deposit protection schemes. Such schemes may be official (as in the United States, Canada and United Kingdom) but frequently they are organized by the banking industry itself with the encouragement of the authorities (as in France, Germany and the Netherlands). Countries which do not have any formal deposit protection arrangements include Italy and Luxembourg.

Typically, the protection offered is territorial in scope, thereby embracing branches and subsidiaries of foreign banks and excluding deposits with foreign offices of domestic banks. However, there are exceptions: the German scheme covers foreign branches of German banks and the Belgian scheme excludes local branches of foreign banks. Foreign currency deposits may or may not be protected, there are variations in the eligibility of both deposits (for instance certificates of deposit) and depositors (most but not all schemes exclude inter-bank deposits) and the size limits imposed on protected deposits vary from the equivalent of under US$20,000 (Canada, United Kingdom) to $100,000 (United States). In addition the United Kingdom and Swiss schemes (as proposed) require that the depositor bear some proportion of any loss. Some schemes provide for a deposit protection fund while others are unfunded but in either case banks are typically subject to a flat-rate contribution based on the total of their deposits (France being an exception in providing for a scale of graduated contributions which discriminates in favor of larger banks).

Lender of Last Resort/Emergency Measures

Generally, national monetary authorities are prepared to provide financial assistance to commercial banks experiencing temporary liquidity difficulties, although in some centers (for instance Luxembourg and Hong Kong) there is no indigenous central bank to perform this function. A distinction can usually be drawn between routine use of the official discount window, where the conditions of access are often formalized, and emergency support operations undertaken on a discretionary basis. In general, emergency assistance is provided directly by the central bank but in some countries (Belgium and Germany) it is channelled through a special fund jointly established by the authorities and the commercial banks. Frequently, such assistance can be offered only to solvent institutions and on a secured basis but some authorities have broader powers of intervention where insolvency is threatened. In other cases (as in the United States and Canada) the deposit insurance agency may have lender of last resort powers which, at least in respect of potentially insolvent institutions, may exceed those of the central bank. Finally, whereas emergency assistance is typically extended directly to troubled banks at a penal interest rate, this is not necessarily the case: for instance, the Bank of Italy's practice is to lend at below market rates to institutions prepared to acquire/assist the problem bank (a technique also employed by the US deposit insurance agency).

As a matter of policy, the precise scope of the lender of last resort function, in the emergency assistance sense, is not publicly stated. However, national authorities generally look to foreign parent institutions for the support of their local subsidiaries and for this purpose some countries (notably the United Kingdom and Canada) require non-legally binding undertakings or 'letters of comfort' from the parent acknowledging responsibility to support its subsidiary beyond the limits of strict legal liability. On the other hand, in the United States subsidiaries as well as branches of foreign banks have a formalized right of access to the central bank's discount window, at least for the purpose of routine liquidity assistance.

Among other emergency measures that may be available are the regulation of interest rates to ease pressures on financial markets (as provided for in France and the Netherlands), assisted mergers, the appointment of caretaker managers to troubled banks and special liquidiation proceedings. In this last case, local branches of foreign banks may, in the event of the parent institution's failure, be subject to separate liquidation proceedings in which case (as under New York State and Dutch law) branch creditors sometimes enjoy a preferential claim to branch assets.

Publications

Study Group Reports:

Toward a Less Unstable International Monetary System
The Reserve Assets Study Group

Foreign Exchange Markets Under Floating Rates
The Exchange Markets Participants' Study Group

Balance-of-Payments Problems of Developing Countries
The Capital Movements and the Growth of International Indebtedness Study Group

The Outlook for International Bank Lending
The Capital Movements and the Growth of International Indebtedness Study Group

Reserve Currencies in Transition
Robert V. Roosa, et al.

How Central Banks Manage Their Reserves
The Multiple Reserve Currency Study Group

Occasional Papers:

1. **Exchange Rates, Domestic Prices, and the Adjustment Process**
   Peter B. Kenen and Clare Pack
2. **Credit Creation in the Euromarket: Alternative Theories and Implications for Control**
   Alexander K. Swoboda
3. **Views of Inflation in the United States**
   Herbert Stein
4. **"Overshooting" in the Foreign Exchange Market**
   Richard M. Levich
5. **Energy in the 1980s — An Analysis of Recent Studies**
   Edwin A. Deagle, Jr., Bijan Mossavar-Rahmani, and Richard Huff
6. **The Role of Official Intervention**
   Micheal Mussa
7. **Coordination of National Economic Policies**
   Jacques Polak
8. **Gradualism vs. Shock Therapy**
   William Fellner, et al.
9. **Policy Choice and Economic Structure**
   John B. Taylor

Publications are available for a small charge or by subscription.

Address inquires to:
The Group of Thirty
Two World Trade Center
Suite 9630
New York, New York 10048
Tel: 212-775-9160

Senator **MATHIAS**. Thank you very much. I am grateful to all the panel for your comments.

Let me just ask you one or two questions each and then I know Senator Proxmire has some questions.

That last point really was the place that I would like to take off on because Mr. de Vries in his table 6 assumed that there would be a 7-percent annual participation by banks, by the private sector.

That would have to include the regional banks, second tier banks, as well as the primary banks. And yet, we hear that the regional banks are very reluctant, No. 1, to stay in at all; No. 2, to increase their lending.

You have been fairly optimistic, Mr. de Vries, in your statement. What is the basis of your optimism that the regional banks will continue to participate, as Mr. Heimann very properly says they should?

Mr. **DE VRIES**. The experience in the last couple of months shows it takes a lot of phone calls and a lot of pressure. I am not a banker, but many of my colleagues are very hard at work around the clock in endless meetings, on things such as the Mexican package of nearly $5 billion. The money is coming in.

Senator **MATHIAS**. There was a word in Washington which is not very fashionable any more, "stroking."

Mr. **DE VRIES**. In times of difficulty like these you have to struggle.

Mr. **SOLOMON**. Stroking.

Senator **MATHIAS**. Stroking. [Laughter.]

Thank you, Mr. Solomon, for that visual exposition of it.

Mr. **DE VRIES**. The 7-percent figure is an abitrary number, you could use 6 or 8 percent. However, 7 percent is a figure that we found reasonable. It is also embedded, as I said, in the agreements with Mexico and with Brazil.

In due course this year, after we are over the hump and maybe we are already over the hump, I would not be surprised that the market could come up with more than 7, 8, or 9 percent.

It is not inconsistent if your main worry is the regionals and not just the regionals of this country but also what I would call the LIFOs, those banks around the world came in last and want to come out the first.

If they do want to opt out, there are enough banks and money in the system that it could be supported by a smaller group and still have a 7-, 8-, or 9-percent increase in loans.

Seven percent is really a fairly low amount, certainly, when historically we were expanding at, say, 20 percent a year. It is a very drastic decline.

The 7-percent figure has emerged in the last few months. At the time of the Toronto meetings there may have been some threats that it was going to be zero. It is going to be better than that and we ought to move up to 7 or 8 percent as a target.

I think when the tides turn, we will be able to do a little bit better than that. We can afford to have the regionals opt out, as Mr. Heimann says.

Mr. **HEIMANN**. May I just add one thing. I think Mr. de Vries' point is very important. We tend to think in terms of U.S. institutions. But this applies outside of the United States in a remarkably high degree.

If one looks at the numbers, the number of smaller banks that became involved in international transactions in the 1970's—non-U.S. smaller banks, many from Arab countries—they also have to be lumped into the supply of funds, the flow of funds from the smaller institutions

Senator **Mathias**. Well, let me respond with a question to you. In your statement you refer to the necessity for a slightly more optimistic outlook. We have not convinced ourselves that we are over the hump and that we need to regain a sense of confidence, and I do not disagree with that.

I think that is part of the problem. Nobody is quite sure whether we have hit bottom or not. Whether we operate on the thesis that we are still descending into the abyss or are climbing out is a critical question for people who have to make these decisions.

But suppose the signs to support an optimistic view are not readily visible. Suppose that it is not clear that growth is about to be resumed. Then, what do we do about the hard cases like Mexico, Brazil, and Argentina?

Mr. **Heimann**. In my view, Senator, the problem is that we must have growth because just adding loans where there is no growth is not going to solve the problem. Again, that has been articulated in a number of fora.

But the reality is that the United States of America must go on a course of economic growth which then becomes the locomotive for the free world. And to say that that will not happen is to consign the LDCs to even deeper economic problems than they have now. Perhaps it can be supported, perhaps it cannot.

But is seems to me that if we have the will, the political will to turn this country around—and I think that it should and does exist—that will in effect begin to resolve the economic problems of the LDCs—not all of the LDCs, they are not all well managed. There are differences in those countries as there are differences in everything else.

But to try to find a solution which is not predicated upon the growth in real terms in this country, I think we are just fooling ourselves.

Senator **Mathias**. Mr. Solomon, do you want to comment on that?

Mr. **Solomon**. Well, I might just try to. I think John Heimann is right, the world needs to have a resumption of economic growth.

I will take your question as you put it. Suppose it turns out to be very slow this year. I do not know what rate of growth in industrial countries was assumed by the International Monetary Fund when it gave its agreement to credits to Mexico and Brazil and asked the commercial banks to come up with loans to those two countries.

But let us assume in line with your question that in fact we get less growth in the industrial countries than was assumed in that projection, so that somewhere in the second half of 1983 we find that Brazil and Mexico have larger current account deficits than was projected and are having trouble financing them. I think that is the nature of your question, if I understand it.

What do we do? We cannot suddenly produce that growth. I hope actions will be taken to try to speed it up, but in the meantime the obvious answer to your question is that more financing will be needed in the meantime to finance the current accounts of those countries.

And it is relevant in that connection that the projected increase in bank loans to those two countries in 1983 is less than the projected increase in bank capital. In other words, while in past years bank loans to those countries have tended to grow faster than capital, this year it is projected to grow less than bank capital. So the bank's exposure is in that sense going down somewhat in 1983.

There is a little scope, therefore, some scope for some increase in bank loans beyond what is now projected to those countries, should it be necessary. Whether more would be available from the IMF, I do not know. But it seems to me there is only one real answer to your question.

The best hope would be to get some renewed growth in the industrial world.

Senator MATHIAS. I do not think you will get any fight from this committee on that proposition.

Mr. de Vries?

Mr. DE VRIES. Mexico and Brazil are difficult to compare. There are similarities and great differences. But I would want to emphasize developments in the last 4 months, particularly, in Mexico, where a new president and a new team have implemented the IMF agreement with great vigor.

The targets are strenuous. I think there is a lot of adjustment that Mexico can make. There was, of course, a euphoria with oil revenues, so they needed cutbacks. Internal adjustment has been started and more can be done.

The targets are ambitious but we are very encouraged by what is being implemented in Mexico. So, in Mexico you have definitely the two elements you need: a recovery in industrial countries, especially the United States and internal adjustment in Mexico. That is being implemented.

Brazil is the same. But the Brazilian debt structure is much better than most countries because they have not been borrowing so much short term as other countries.

Brazil is a country that needs a lot of long-term funds, and there is where I particularly want to bring in the World Bank. The so-called graduation scheme of the Bank is very nice but it is always a matter of timing. We are not always correct in the timing of these developments.

The current debt crisis is a setback for these countries to go to the bond markets. Countries do need, particularly in cases like Brazil, a lot of long-term money. In the past few years, they have been financing dams and so on through the market at 8 years. Maybe that should have been done on a 30-year basis through the World Bank.

That is why I want to stress a little more reconsideration of the thinking of the World Bank, particularly for countries like Brazil. They could easily need billions of dollars from the World Bank in long-term, really long-term money.

Senator MATHIAS. You are talking about billions of dollars in long-term money for Brazil, and you have already talked about additional money for the IMF.

But we in Congress have a problem about these billions that you talk about. They have to come from somewhere and basically they are coming from American taxpayers, a lot of small taxpayers.

I have in my State of Maryland a lot of unemployed people. In the Baltimore area, for example, two of our major industries are steel and shipbuilding. Where you have steel and shipbuilding today, you have a lot of people out of work.

Now, how can I go to Baltimore and explain to the steelworkers and the shipyard workers that I am voting to give another $9 billion to the IMF? How can I explain to them that it is in their interest?

Mr. DE VRIES. I have a figure in my statement that for every $10 billion of U.S. exports 200,000 jobs are created.

The way this has to be approached is, as I said in a number of places—and I think the panel agrees—that the debt problem is a world economic problem. If we do not help one another, we will go down even further. There will be far more unemployment which will be far more important than the $8 billion or $9 billion that you may have to put up for the IMF. The cost of further loss of economic growth would be huge.

In numerical terms, the IMF quota increase is a great amount of money, but in terms of GNPs, world GNPs, it is a very small amount. The benefit for bringing about world recovery is very large. And maintaining or returning to, within 2 to 3 years, a viable rate of growth in Latin America of 5, 6, or 7 percent is vital to the U.S. exports and employment. That is the justification.

Without making a cooperative effort, we are going to go down. The risks of the 1930's are here. In the 1930's we experienced the high unemployment, protectionism, competitive devaluation, and debt problems that created the prolonged period of economic misery.

Then we had Bretton Woods where we created institutions so we would not come back to the same miserable economic situations. Now we have a lot of the same elements but we have the institutions and we must use them. I think the comparative cost of these institutions is infinitesimal and the benefits far more than if we did not support them.

Senator PROXMIRE. Mr. de Vries, you gave us some interesting enlightenment on the kind of data available to the banks when they make loans.

I think this is critically important because, as we all know, most of the credit has to be made available or is going to be made available—we hope—by the private sector. The ratio is what, 4 to 1, something like that? Eighty percent of the money would be private.

And, of course, any banker would want to have the best possible data and should have it, and should make his judgment based on whether or not the loan would be sound.

You said that the data collected by the Federal Reserve and the Bank for International Settlements is comprehensive although it may not be current. There may be gaps in the data. Those gaps may be very important.

Do we have a data system in which banks, your bank, Morgan Bank, or a bank in Wisconsin, called upon to make a loan to a particular country would know the country's current exposure to other banks?

And if we do have such a system, would such a system be desirable? If we do not have it, I should say, would such a system be desirable and how should we go about developing it?

Mr. DE VRIES. May I clarify one point of your question? You are asking me whether we have a system by which we have current information about each bank's individual exposure to a particular country?

Senator PROXMIRE. I am not asking for that in detail. If a bank is to make a loan to Mexico or a bank is to make a loan to Poland or wherever, is it possible for the bank to know what the exposure of the country to which they would make the loan, what the exposure is?

Mr. DE VRIES. Yes.

Senator PROXMIRE. Up to date? Reasonably up to date?

Mr. DE VRIES. Yes; the tables that you have in the back of my statement are dated June 30. They include the latest statistics we have from the BIS.

Senator PROXMIRE. That is June 30, 1982, 6 months ago.

Mr. DE VRIES. That is correct. They are 6 months old but, of course, it takes time to collect the data, to process them, to check the data, to wait for everybody to send the number in.

Senator PROXMIRE. I realize that there is reason for that. I am just wondering if you, as a banker, can advise us as to whether or not you think data of that kind is sufficient.

Mr. DE VRIES. We have estimates for the end of 1982. We can make reasonable estimates about their borrowing and current account deficits in the second half of the year. We update them from our internal sources. And these data are published.

Senator PROXMIRE. Well, of course, you are representing one of the truly great banks, Morgan Guaranty. Is it possible for these regional banks?

Mr. DE VRIES. Yes.

Senator PROXMIRE. Can any bank, could a reasonably modest bank in my State, or in Chairman Mathias' State, with confidence get the kind of information they need to make a loan with good judgment?

Mr. DE VRIES. Yes, sir, it is unfortunate that I do not have it with me, but we have a so-called "Green Book," formally called, "Morgan International Data," which has very extensive data on total debt, bank debt, debt service ratios, et cetera, on a great many countries, which we make available to anybody for a very modest fee. [Laughter.]

Senator PROXMIRE. I am sorry, I missed that.

Mr. DE VRIES. We make them available for a very modest fee. We sell them to anybody.

Senator MATHIAS. You do not give them away.

Mr. DE VRIES. Well, there is no free lunch, Senator. [Laughter.]

Senator PROXMIRE. What about unutilized lines of credit which can run up totals quickly?

Mr. de Vries. I think the BIS and the Federal Reserve have some information about unused or undisbursed credit commitments, but not on unused lines of credit for which there is no legal obligation.

Senator Proxmire. Is that not a critical element?

Mr. de Vries. Unused lines? An unused line can be cut at an instants notice. It is not much good to know how much the unused lines were 6 months ago, they may no longer be in existence.

What I refer to is when the emergencies come and we start looking in detail at the data, the data are soft. Suppose according to the IMF the latest number, say, for the external assets of a country was $5 billion, 9 months ago. Incidentally, the problem starts when the IMF does not publish recent data, say, on external assets. But even if you then take the most recent number and you start investigating what is in it, you may find out in some cases that the country's external assets included a lot of short-term claims on Bulgaria, or Hungary, which are delinquent in paying and thus are nonliquid reserve assets.

Maybe a country will include in its reserves assets, claims on countries which are not current. We need better information. Another example, a country may include in its reserves gold that was swapped and is not available on a liquid basis.

That is the sort of information we need.

On the debt side we do have, I think, pretty comprehensive data. I think the BIS has done amazingly good work in the last 4 or 5 years. But again, there is the short-term area. We in the bank do a lot of extra work to make very sure that what is included in the debt indeed includes all the short-term debt.

Also, you might have inadequate information about all dollar liabilities. External debt, after all, is a liability to a foreigner. What about dollar liabilities to residents as you would have in the case of Mexico, the so-called Mexdollars?

These were dollar deposits in Mexico frequently by Mexican residents. It is not an external debt, it is a dollar debt. These are some of the issues that are not always captured in external debt data, which in time of crisis are very important numbers.

There are always, we feel, gaps of information and the statistics could be improved.

Senator Proxmire. Well, let me say what bothers me. There was an article in the New York Times on January 12 that said, "World-Wide Debt Data for Banks" as the headline.

It worried about shaky loans abroad and the threat they pose to the world banking system.

> Thirty-five international banks today formed a clearing house to collect financial information on countries that have problems paying their foreign debts. The main goal of the Washington-based private organization—named the Institute of International Finance—is to improve the quality and availability of data that lenders use to make decisions about extending new credit to countries or in renegotiating the terms of existing loans.

This was only a week ago—are they wasting their time? Do they know all that anyway?

Mr. de Vries. No; I support the institute. I find that probably one of the most useful aspects of that new institute is to improve the data. I think that is a very useful function that needs our support. That is a private initiative.

Senator PROXMIRE. Let me ask each of you briefly to comment on this next question which, I think, is really fundamental.

Everybody agrees that world recovery is a critical part of the solution of the debt problem. You said that that is essential. If we do not get world recovery—I think as the chairman has indicated—IMF assistance as a Band-Aid just will not do the job.

At any rate—and I may ask Mr. Heimann first—are you satisfied that the administration's policies will achieve a sustained and adequate U.S. recovery? Since so much of world recovery depends upon this country it seems to me we would have to lead the way.

Mr. HEIMANN. No, I am not.

Senator PROXMIRE. Why not?

Mr. HEIMANN. Well, I am just talking from the evidence. No; I am not satisfied that the present policies will achieve the goals that we are talking about.

I do not see it in the present programs. I do not see the kind of forward planning, economic planning that is necessary considering where we start from—which is today—and the problems of the recession in the United States.

No; I do not support the policies as I understand them—though I have some problems understanding what the policies are.

Senator PROXMIRE. Supposing you were advising President Reagan now, what would you propose as one of the two or three most important things he could do to provide for policies which would help our recovery and world recovery?

Mr. HEIMANN. There are a number of areas, of course, that have been debated upon at some great length. I do not think we want to take the time to go through each one of them.

Senator PROXMIRE. See what you can do in about a minute.

Mr. HEIMANN. I personally applaud the action taken by the Greenspan commission. I think finally there seems to be a correct approach.

But as for the further cuts in social entitlement programs—that is a personal view—I think we have cut much too far and affected the people in this country who can least afford it. So, I do not see solutions in cutting social entitlement programs and transfer programs, other than what is being done—hopefully done—with the social security program.

As far as the military is concerned, my own view is—having been in Government—that all large budgets can be cut in Government de facto. It is not fraud, waste, and abuse, it is just the function of Government and how it operates, and the appropriations process, et cetera.

So, I suspect that there is always room, without getting into the debate if you will, as to whether the military expenditures are too high or too low. Personally, I think that has been overdone, that they can be stretched out. We can accomplish the same goals without the kind of budgetary impact that they are having at the present time. I am not a specialist in that so I would not argue it, but I strongly feel that.

Third, I think that we have to get to a point at which the people who supply us the funds—meaning both taxpayers and investors *who lend money to this* Government—begin to believe that we have a long-term solution to our financial problems in this country. We clearly have a budget deficit. It is not going to go away immediately. You cannot make it disappear in the middle of a recession.

So, my own view is that we should create a taxable taxing program——

Senator **Proxmire**. Create what program?

Mr. **Heimann**. A program of taxation which will stretch itself out over a period of time—it should be energy related—that would be approved by the Congress but implemented by the President. And the purpose of which would be simply to say that we have decided that as we come out of the recession, we will reduce these deficits. We have a program in place which can reduce these deficits as they exist now and may exist in the future.

Senator **Proxmire**. Reducing a deficit is not the way to expand, I agree with you wholeheartedly.

Mr. **Heimann**. I am talking about in the long run.

Senator **Proxmire**. But we cannot expand the economy that way in the next year or 2, or 3, to reduce the deficit.

Mr. **Heimann**. I agree.

Senator **Proxmire**. Is that not right?

Mr. **Heimann**. That is correct.

Senator **Proxmire**. Then what do we do, monetary policy?

Mr. **Heimann**. Well, monetary policy is the purpose I am coming to. Actually, I was trying to get us to the interest rates because the phenomenon here is the high interest rates that are still being borne. If you look at the rate of interest, it is high in real terms—I think the highest since 1921.

But interest rates are set by the perceptions of the market, the people who invest money. It cannot be dominated by Government except in a reinflationary mode which, I think, all of us would feel would be quite counterproductive and would set off another set of problems.

Therefore, my suggestion would be for a program of taxation over the years which would convince the markets, the suppliers of funds, that the programs by which we are getting this country going again are not reinflationary—that is, for example, printing money. I do not want to get into definitions on that.

But that there is a methodology by which we can pay for what we need that does not increase, if you will, the pressures of the recession at the present time. But a forward-looking program in place so that the funds are available to, in a sense, balance the budgets over a long period of time in terms of our deficits. Not this year.

Reinflation I do not think solves any problem. My great fear would be a substantial change in those policies. To go back into the spiral of inflation would be much more damaging 3, 4, 5 years out than anything we have experienced in the past.

Senator **Proxmire**. Mr. Solomon?

Mr. **Solomon**. I do not think I disagree, really, with what John Heimann has said, Mr. Chairman.

I first want to agree with you very strongly that reducing a budget deficit is not the way to recover from a recession. You may want to reduce the budget deficits later on. The common phrase is, we worry about the outyears, whatever those are, and not this year.

Beyond that—and I agree with John about the need for a longer run control of the budget deficits—there is a lot of confusion about what those numbers will be when the economy is back to a high level of employment.

The other element is monetary policy. It is very hard to characterize what monetary policy has done in the last few months, and I think I have some basis for judging it, having spent half my life with the Federal Reserve Board. But I judge the Fed by what it does rather than by what it says.

What it has done on the whole since midyear is to give us a very substantial decline in interest rate. One hopes that will go further, and one has the impression that the Fed would like to see it go farther. But the Fed is running into market perceptions and it is hard to deal with those.

Senator PROXMIRE. Is not that decline in interest rates the product of the recession, though? Is it not because there has been such a paralysis of lending in the domestic economy?

We just have not had the lending for buying homes or buying cars. It is picking up a little now but it is so far below. After all, we are operating at the lowest level of capacity since the Great Depression—67 percent of capacity in December 1982. The lowest level of capacity we have had, as I say, since 1939.

So, at that level with very little demand for funds from the private sector, of course, interest rates are low. With the recovery, are we going to have that?

Mr. SOLOMON. There was very little demand in the first half of the year. The economy was hardly booming in the first half of 1982 but interest rates were rising. We have had a big drop only since midyear.

While I agree with you that the weak economy is contributing to low interest rates, I believe that in addition to that, what the Fed has done has contributed to the decline in interest rates.

Senator PROXMIRE. Mr. de Vries?

Mr. DE VRIES. Very briefly, we definitely need greater clarity and certainty about monetary policy.

I would just like to add that if you look at the monetary aggregates and if you follow these aggregates, you may expect higher interest rates. There are a lot of people who are focusing on the aggregates who believe that we are already heading for more inflation and for higher interest rates.

So, I think point No. 1 is, the market wants more clarity and more certainty about monetary policy.

Second, we must, as the previous speaker indicated, focus on the long-term budget outlook.

I find that we have unfortunately not reduced enough Government spending. In the current issue of our publication we have a long assessment of Margaret Thatcher's policies and have made some comparison between Britain and the United States.

Despite many statements and promises, Government spending has not been sufficiently cut back in both the United Kingdom and the United States. If we want to make room for the private sector we have to tackle a little bit harder the reduction of the public sector.

I would like to add one other area—wage behavior—because I find it is interesting to observe that in many countries real wages have been rising despite high unemployment. That is rather strange. If you have an oversupply of labor, why would real wages rise? It certainly points up a problem we probably face—not in the United States so much but in many countries. But still we have the choice of maintaining real wages for those who are employed or creating more jobs. There is a tradeoff here.

I would not call for an incomes policy but to a greater certainty of monetary policy at this stage and the long-term budget problem, we need to bring in industrial wage behavior in order to dampen the inflationary expectations. We would be remiss if we would entirely overlook wage behavior here.

Senator **PROXMIRE**. The chairman is very anxious to get on to the other panel and so am I. In courtesy, I think we have to do that.

But I would like to ask one more question if I might, Mr. Chairman. I apologize for taking so much time. It is such a good panel.

Frankly, gentlemen, I am disappointed. I think it is a fine panel and you are brilliant people, but I just wonder if there is any answer to the question I asked because we are in this terrible dilemma.

You are absolutely right, we have to continue to do our best to create a situation where we can have relatively noninflationary recovery, hold down deficits, and at the same time find a way to stimulate the economy. As William Chesney Martin used to say, "You cannot push on a string." I know, monetary policy cannot do it by itself. Let my just ask this question of Mr. Solomon.

Mr. Solomon, I just cannot resist asking you this because it was such a remarkable statement and it shocked me. In your statement you say,

> It has been charged by some that the Fund is merely bailing out the banks This is patently incorrect. As someone has said, the IMF is bailing in the banks by requiring them to increase their loans to the countries to which it is lending.

How in the world can you require a private bank in the United States to make a loan to a particular country? How can the First Wisconsin Bank in Milwaukee be required to make a loan to Mexico, for example; how can you do that? How can anybody do that, even John Heimann?

Mr. **SOLOMON**. Right. [Laughter.]

Good question, Senator. I expected it. I do not know all the mechanics of how we got from the large banks to your bank in Wisconsin.

I do know that the Managing Director of the International Monetary Fund, M. de Larosiere, met with the representatives of the banks—the larger banks, presumably, from around the world, not just American banks. Banks that lend to Mexico. He met with them and he said,

> You expect the Fund to make a loan to Mexico. The Fund is not able to make a loan to Mexico that is viable and makes sense unless Mexico has assurance that its total current account, its balance of payments, will be financed in 1983. I expect the banks that have loaned to Mexico in the past to come up with * * *

I think it is $5 billion.

"I expect each bank that has a loan to Mexico to increase its exposure by"—I believe the figure was 7 percent.

Senator PROXMIRE. Did he get them to sign on the dotted line in writing?

Mr. SOLOMON. I do not know the mechanics of this, Mr. Chairman, and I do not know how that message got from the 30 or so banks that attended the meeting with M. de Larosiere to your bank in Wisconsin. But I do know that very high percentage of that $5 billion has now been committed.

Without answering you in terms of mechanics, I am answering you in terms of results.

Senator PROXMIRE. Well, that is very reassuring. I had not heard that before.

Mr. Chairman, I will not ask any further questions but I do have a whole series of questions I wanted to ask John Heimann. I would request him, if he would, to answer them for the record.

Mr. HEIMANN. I would be delighted to, Senator.

Senator PROXMIRE. I hesitate to impose on you. You are a private citizen now but very helpful. [Laughter.]

You have had marvelous experience in the Government.

Mr. HEIMANN. I will be delighted to help.

Senator MATHIAS. Let me broaden that request to all members of the panel. We have, obviously, a number of other questions and it would be extremely helpful to the committee if we could pose some of them to you in writing—we do not want it to be too burdensome—and ask you to respond for the record.

Let me ask just one very quick question, and Mr. Heimann would be particularly qualified to answer it.

Do the current regulations that limit lending to central governments cover that subject adequately? Are U.S. banks protected from becoming overexposed to any single borrowing nation?

Mr. HEIMANN. Senator, we do have rules of diversification. I have been gone for 1½ years, I cannot remember the exact number of the rule any more.

But I think that we ought to face the reality of what the problem is. Yes, there are diversification rules written into the National Banking Act and then in the Federal Reserve System.

But most well-managed banks create diversification in their own portfolios as they think are best for the bank in terms of their operations, the scope of the bank, where it functions, the kinds of currencies it collects, et cetera.

Badly managed banks can find all sorts of ways around the diversification rules. I mean, there is the bitter experience here that law does not make good bankers and it does not make bad bankers, all that does is form some level of protection under which the supervisory agencies can step in if it becomes clear that an institution has gone off the deep end—whatever that might be.

Now, the Congress has just increased, as you know, the percentage of capital and surplus for a national bank that can be lent directly to any one borrower, and that has gone from 10 to 15 percent.

I was not here at the time when the Congress took that action. It was clearly designed to be of assistance to smaller banks in this country who were having very real problems in servicing the clients of the smaller banks because of the 10-percent limitation.

On the other hand, I do not think that that increase to 15 percent should give license to larger banks to say, "Now we can increase our loan limits to whomsoever at 15 percent," unless there is true diversification in their portfolio and they have the kind of quality management and understanding of the loans they are making.

That is not the same in all banking institutions.

Senator MATHIAS. Your answer supports my philosophical view that there are not formulae that you could apply to human behavior that answer all occasions. I think you are right about that.

Thank you all very much.

Mr. HEIMANN. Thank you, Senator.

Senator MATHIAS. We now come to Mr. Rohatyn and Mr. Cline.

Mr. Rohatyn, this brings us to a certain degree of déjà vu because you and Senator Proxmire and I faced each other for many hours on the subject of Big Mack.

Mr. ROHATYN. Mr. Chairman, we are just bringing the New York City problem to the worldwide level. I think that is quite appropriate. [Laughter.]

I am delighted to be here, I appreciate it. I enjoy testifying in front of your subcommittee and enjoyed jousting with Senator Proxmire for 2 or 3 years. And I mostly enjoy the fact that the result was eminently successful.

Senator PROXMIRE. You won, I lost.

Mr. ROHATYN. Senator, we both won. [Laughter.]

Senator MATHIAS. Gentlemen, do you have any choice as to who will go first?

Mr. ROHATYN. I will be brief, Senator.

Senator MATHIAS. The rule still applies that your full statement will appear in the record and you can summarize it briefly.

[Mr. Rohatyn's biographical data follows:]

BIOGRAPHICAL DATA OF FELIX G. ROHATYN

Mr. Felix G. Rohatyn was born in Vienna, Austria on May 29, 1928. He graduated from Middlebury College in Vermont, in 1948. He has been a partner of Lazard Freres & Co. since 1960.

Mr. Rohatyn is a director of various companies, including Schlumberger Corporation (effective May 6, 1981), Owens-Illinois, Inc., Pfizer Inc., MCA Corporation, Minerals & Resources Corp., Ltd., American Motors Corp. and Pechiney Ugine Kuhlmann Corp. He is a director of the New York Heart Asociation and the New York Philharmonic. He is Chairman of the Municipal Assistance Corporation for the City of New York, and a former member of the Emergency Financial Control Board. Mr. Rohatyn is currently Special Economic Advisor to the Governor of New York, Hugh L. Carey. He is also a former governor of the New York Stock Exchange.

Mr. Rohatyn holds the honorary degree of Doctor of Laws from Adelphi University, Bard College and New York University.

Mr. Rohatyn resides in New York City.

STATEMENT OF FELIX G. ROHATYN, SENIOR PARTNER, LAZARD FRERES & CO., NEW YORK, N.Y.

Mr. ROHATYN. Thank you. I will just summarize my statement, Mr. Chairman.

I have a maybe somewhat more grim view of the outlook for the worldwide situation than some. I think there are two main dangers in the world today. One is of accidental military confrontation and the other is a financial and economic crisis as a result of a series of defaulting creditors and resulting protectionism. I think of the two the latter is probably at least as serious as the former.

I think your subcommittee undoubtedly has all of the statistics of country exposure, of bank exposure. I also do not think there is any particular need to ascertain how we got to where we are. I think the list of causes and of mistakes is probably long enough to fill several volumes.

So, basically I would like to address myself to two issues. One is how we can avoid a crisis and, second, how we can resolve the problem.

Those are, I think, quite separate. Although, if we cannot avoid a crisis we will never solve the problem. I would like to look at both of them separately.

We did avoid a crisis in the summer of 1982 and your deliberations regarding U.S. participation in the IMF are clearly central to that issue. The IMF and the Bank for International Settlements were the crisis managers last summer. I think they are likely to remain that for quite some time to come, and additional resources to the IMF are quite vital.

But by themselves I do not think that they are necessarily sufficient. We had a watershed in the debt situation in 1982. On the one hand, the situation was aggravated by large additional credits to Mexico, Brazil, et cetera, at a time when their situation was getting more and more perilous.

But on the other hand it was much improved by the fact that the world as a whole and the United States in particular recognized that this problem was, one, a major problem; and two, that we had to do something about it.

I think the fact that the United States recognized in 1982 that we live in an interconnected world, that U.S. policy changed by 180 degrees from the Ottawa Conference when we took the position that there were no increases needed in the IMF and that there were no real problems that could not be solved by the marketplace and the present attitude of supporting these institutions and calling for growth, I think, probably is the best single development that occurred in 1982.

The default of Poland in 1982 should have awakened us to the reality of what was happening. But we did not do so, one, because bank exposure in the United States was limited and, second, because it became mixed into ideological and geopolitical considerations.

So that it was only when Mexico defaulted, followed shortly thereafter by Brazil, that the U.S. Government and the Federal Reserve took the lead in preventing a banking crisis.

The Fed lowered its interest rate structures, changed its monetary policy quite drastically—very late in the day but it did prevent a crisis. And the Federal Reserve and the IMF and the commercial banks put together the rescue packages that were needed and did it brilliantly. They should get a great deal of credit for that.

However, I think we have to recognize a very fundamental fact which is that we have become prisoners of our debtors. That today

Poland, Mexico, Argentina, Brazil, and Romania have all unilaterally defaulted on their debts, and that they are in effect dictating rescheduling terms to our banks.

Poland, as I read in the paper the other day, has gone so far as to include their rescheduling in the 1983 budget before any discussions with the Western banks.

I think the acquiescence of our banks in this rescheduling is probably a matter in which they have very little choice in the questions of Eastern Europe, to which I will come back.

It is perfectly clear that for the time a significantly beefed-up IMF with bank loan reschedulings is the only thing that stands between us and a crisis.

I think the potential danger still lurking in the system is not an accidental country default. We have had defaults. We call them something else because those defaults that are not accidental can be papered over by rescheduling without requiring major write-downs of a bank's capital.

I do believe there exists the danger of a unilateral repudiation of external debt by a country that is politically radicalized by depression or by IMF-imposed austerity, or a combination of both.

I recognize that many bankers whom I respect believe that this is out of the question, but I respectfully disagree. Although I may not believe that it is likely, I think it is possible. And the longer we have a worldwide economic depression the greater this risk is.

That kind of a repudiation would require for legal and accounting reasons very drastic write-downs in the capital of many large banks, possibly impairing the capacity of several of these banks to function.

Senator **Mathias**. Let me interrupt you. When you say the ability of banks to function, does that mean belly-up?

Mr. **Rohatyn**. It can mean a variety of things, Mr. Chairman. But at the very least it will impair their ability to provide credit on the scale that it is required for this country to grow, much less for the rest of the world to grow.

The Federal Reserve can provide all the liquidity in the world to a bank in difficulty, but there is no Government institution today that can provide permanent capital to a bank in difficulty. I think at the very least as a preventive measure the Federal Reserve or some other institution—whether it is a new version of the RFC or else—should be given the power in case of an emergency to acquire equity securities, preferred stock or common stock, of a bank in difficulty. I think that would provide a safety net that does not exist today.

Another risk in the system today is a bank failure in a country where there is no jurisdiction, no central bank jurisdiction at this point. We saw Banco Ambrosiano which lost over $1 billion, which was not covered by any jurisdictions. I think the areas of responsibility among central banks today should be broadened to include some these countries in some of these areas.

Now those are, I would think, short-term measures that might be at least thought about to get greater protection for the avoidance of a possible crisis.

In terms of resolution of the problem those again—and I am repeating what the other witnesses said—the first condition for that has to be strong economic growth among the industrial countries, together with open trade policies.

But second, I do believe that a long-term, low-interest resheduling of much of the Third World debt is necessary to provide breathing room.

The current economic forecast of 1.4 percent growth in the United States, practically no growth in Western Europe, and low growth in Japan, really are a disaster scenario for this kind of an economic recovery.

The current practice of rolling over debt principal and capitalizing interest costs year by year is a bridge that leads you nowhere. What you are doing is probably doubling the debt every 4 years if you do not have real growth to begin paying the debt down.

So that inevitably you have to have coordinated Western growth, together with liberal trade. In order to achieve that growth, I think you are going to have to have monetary policies and fiscal policies that are much more expansive and that have to be agreed upon among at least Germany, the United Kingdom, Japan, and the United States.

And in order to do that, I think some kind of stabilization within realistic limits of the main world trading currencies is a necessity. We have really never replaced Bretton Woods since 1971 except with this system of wildly fluctuating currencies, which in effect has kind of an upside-down effect. It used to be that trade policies resulted in monetary movements. Today, currency movements are the things that affect trade policy.

It is impossible to consider, in my judgment, a real recovery, sustained recovery in the industrial West, without stabilized exchange rates—at least within some limits.

So, I think that as you look at this particular issue, the question of an economic conference—not to copy Bretton Woods but to substitute a more orderly system along the lines of Bretton Woods—is something that is urgently required.

I am not advocating going back to fixed rates but certainly to a band within which the rates of the main world trading currencies would operate, which require coordination of central banks and monetary policy.

I also think realistically you have to look at the issue of debt stretch-out. You have debtor countries today whose debt service is more than 100 percent of export earnings. These rollovers are not attenuating the problems sufficiently. And asking the banks to provide new credits to borrowers that are already choking on the old ones, I do not think helps either the lenders or the borrowers.

And in looking at this problem, I think we should be realistic about the substance and worry about the form a little later.

I think the reality of the situation is that of the $500 billion to $700 billion that are presently on loan to the Third World, to Eastern Europe, to the Soviet Union, et cetera, this money will only come back over a very long time, if ever.

And instead of maintaining the fiction that these are short-term high-interest loans and asking the banks to increase their commitments, it might be better for both lenders and borrowers to create a mechanism which would stretch those existing loans out to 25 to 30 years at lower interest rates.

For instance, if you took $300 billion of that world debt and stretched it out over 25 years with, say, 6 percent interest, you would be providing about $15 billion to $20 billion of immediate interest relief to these countries that are already in great difficulties, and you would also reduce the pressure for additional credits at this point.

I think what you would then try to do is to reschedule the balance of the debt so that the debt service of any debtor country not exceed, say, 25 to 33 percent of their exports.

Now, I am perfectly aware of the fact that such a program involves the recognition of costs and the recognition of losses because a 25-year, 6-percent loan is worth a lot less on its face than a short-term 13-percent loan. And the allocation of such a cost between the banks, their stockholders, the taxpayers, and the countries would be the subject of a difficult negotiation. However, if you were successful I think you would have daylight at the end of the tunnel.

I think the present approach of combining IMF austerity programs while keeping borrowers under continuing crushing debt service pressure could be very self-defeating. Unless a strong, worldwide recovery is to occur soon—which really seems unlikely to me—I think the potential for social and political radicalization will become greater and greater.

The mechanism of this kind of a stretchout is not difficult to determine once it is decided how to allocate the costs. You could do it through a subsidiary of the World Bank; you could do it through a subsidiary of the IMF or a new institution that would be guaranteed by various governments which in effect would take over the bank's debts and give the banks long-term low-interest loans of its own, and do a mirror transaction with the borrowing countries.

As far as the banks are concerned, they would suffer a significant loss of income because of the lower interest rates, but they would have much greater security because the paper they got would be a better paper.

So I think you could protect their balance sheets to some extent. They would have to pay a price, but I think that is inevitable.

I think some subsidiary questions have to be raised, whether there should be a change in the regulatory aspects of the banking system. And I think to me clearly the concept of aggregate country risk should be included in the legal lending limits of American banks.

I think the question of whether commercial banks should lend to foreign governments on a long-term basis, is a valid issue to be looked at. I have my own views on Eastern Europe. I think that long-term loans to Communist governments should be done government-to-government and that they should be part of a strategic dialog between us and the Soviet Union.

I think the Soviet Union should bear its share of the financing of Eastern Europe, but that is a different and separate issue.

I do believe, however, that long-term loans are not the province of commercial banks but rather of the public markets, or of insurance companies, or of governments. And if loans to foreign governments by definition are long term, I wonder whether this is appropriate for the banking system on as large a scale as we have been doing.

One last, again subsidiary, question concerns OPEC. I think both OPEC and the Soviet Union have not borne their fair share of financing the Third World. We have financed three times the price increases of OPEC. We have paid our money over to them. We have borne the inflation, and now we are paying off the debts of the Third World.

I apologize for roaming a little beyond the limits that you may have set for this, but I do think that if we are going to solve this problem we need coordinated, aggressive economic growth policies among the West.

We need an orderly international monetary system—whether by the main trading currencies or maintained within given ranges. We need a long-term, low-interest refinancing of a significant part of the world debt. We need participation by OPEC and by the Soviets in their respective areas, and I think we need maintenance of liberal trade policies throughout the world.

I am not naive, Mr. Chairman, I do not think that is easy. But I think that these issues are fundamental and unless you are papering over the problem, they have to be faced.

Thank you, Mr. Chairman.

[Mr. Rohatyn's prepared statement follows:]

PREPARED STATEMENT OF FELIX G. ROHATYN

Mr. Chairman, members of the committee, I am grateful for the opportunity to testify on the "International Financial System" and, specifically, the problems of the global debt. As you deliberate additional American commitments to the IMF, the problems created by the current world debt situation and its possible resolution have to be examined together.

The Western world, today, faces two dangers:

(1) The danger of accidental military confrontation with the Soviet Union as a result of a flareup in the Middle East, Eastern Europe or elsewhere in the world;

(2) The danger of a financial and economic crisis as a result of defaulting large creditors and protectionism, with world-wide repercussions.

Of these two dangers, I believe the latter to be at least as immediate and as potentially lethal as the former.

There is no need for me to review the dimensions and the details of the world debt situation. Your Committee, I am sure, has all the necessary statistics about country debt as well as the exposure of American banks and that of their Canadian, European and Japanese counterparts. The numbers are obviously grim.

There is also no particular need to try to ascertain how we came to this situation and who, if anyone, is to blame. The truth, as in Rashomon, is many-faceted. The oil shocks of the 1970's, our weak response thereto, petrodollar recycling, the inflation resulting from the Vietnam war, overaggressive lending by banks and excessive borrowings by countries and corporations, inadequate regulation in international lending, the deflationary shock of our recent monetary policies; all of these contributed. I learned at the time of the New York City financial crisis of 1975-76, that when a crisis looms the priority should be to resolve it first and leave to historians the questions of analyzing cause and allocating blame.

I will therefore address myself to two general issues: (1) How to avoid a crisis; (2) How to resolve the problem.

These are separate and distinct issues and, although if we are not successful in crisis avoidance we will never get to the question of resolution, they must nonetheless be viewed separately.

1. AVOIDING A CRISIS

A crisis was avoided in the Summer of 1982. The deliberations of your Committee regarding increased U.S. participation in the IMF are central to this issue. The IMF and the Bank for International Settlements (BIS) have been the real crisis managers for the past year; they are likely to remain so for the foreseeable future. Additional resources to the IMF, both directly and for an emergency fund are absolutely vital. By themselves, however, they may not be enough.

The year 1982 was a watershed for the world debt situation. This situation was considerably aggravated by large additional banking credits granted to Mexico, Brazil, etc., at a time when their economic situation was already deteriorating rapidly. It was, however, ultimately much improved by the fact that the world, and principally the United States, recognized first, that a major problem existed and second, that we had to do something about it.

The United States now recognizes that we live in an interconnected world, whether we like it or not. The fact that the U.S. Government changed its attitude by 180 degrees, between the Ottawa Conference (when we refused to recognize the need for significantly greater IMF funding) and the present, is probably the most important fundamental improvement in the situation.

The default of Poland, at the end of 1981, should have awakened us to the reality of the situation. It did not do so, first, because American bank exposure was limited and second, because it became mixed up with ideological and geopolitical considerations. When Mexico defaulted, followed shortly thereafter by Brazil, the U.S. Government and the Federal Reserve Bank took the lead in preventing a banking crisis, then and there. Simultaneously, the Fed drastically, and quite correctly, eased its monetary policy and lowered interest rates and, together with the IMF and commercial banks put together the necessary rescue packages. These were brilliant crisis management operations for which our Treasury, the Fed, the participant banks deserve great credit; they bought us valuable time, but the danger is still there.

We must recognize a fundamental fact: We have become the prisoners of our debtors, Poland, Mexico, Argentina, Brazil and now Rumania have all, unilaterally, defaulted on their debts and are, in effect, dictating rescheduling terms to our banks. Poland has now gone so far as to include $3 billion of 1983 debts, which will not be repaid, as a saving in her current budget. The acquiescence of our banks in rescheduling both interest and principal is now taken for granted and, with the exception of Eastern Europe to which I will revert, our banks have really no choice.

It is clear that, for the time being, a significantly beefed-up IMF, together with bank loan reschedulings, are needed to continue to avoid a crisis.

The potential danger still lurking in the system is not an accidental country default; we have had defaults (in fact if not in name) and they can be papered over by rescheduling, without requiring major write-downs of a bank's capital. On the other hand, there does exist the danger of a unilateral repudiation of external debt by a country politically radicalized by economic depression, and IMF-imposed austerity. Many responsible bankers believe this to be out-of-the-question; although it may be unlikely, I do not believe it to be impossible. The longer the world-wide economic depression goes on, the greater the risk. Such repudiation would require, for legal and accounting reasons, drastic writedowns of the capital of many large banks, possibly impairing the capacity of several to function. Although the Fed can provide liquidity, no government insitution currently exists to provide permanent capital to a bank in difficulty. As a preventive measure, the Fed or a new version of a Reconstruction Finance Corporation (RFC) should have the authority to acquire common or preferred stock of a bank in difficulty, as the RFC did in the 1930's. This would provide a safety net where none currently exists.

Another current risk is the risk of bank failure in a jurisdiction where no strong central bank exists. Banco Ambrosiano, which is reported to have lost over $1 billion overseas, is a striking example. Banks operating in tax-shelter countries like the Bahamas or Cayman Islands could fail and trigger a chain reaction difficult to contain. The allocation of responsibility among central banks should be increased beyond their respective borders to respond to a possible problem in those areas.

The current improved coordination among central banks, the IMF, the BIS and the commercial banks, together with our own government's recognition of the gravity of the problems are the most important factors in preventing a crisis. The additional steps I have suggested would provide further needed insurance.

2. RESOLVING THE PROBLEM

The problems caused by the overhang of world-debt can only be addressed within a framework which provides for:

(a) Strong economic growth among the industrial countries, together with international trade policies that are as open as possible;

(b) Long-term, low interest rescheduling of much of the Third World debt to provide economic breathing room to the Third World.

The current economic forecasts of 1.4 percent real GNP growth in the United States, practically no growth in Western Europe, lower-than historic growth rate in Japan, bode ill for the world debt problem. The current practice of rolling over debt principal and capitalizing interest costs year by year, is a bridge to nowhere. The result will be a doubling of the debt every 4 or 5 years and an inevitable breakdown in the system.

Coordinated Western growth is required together with liberalized trade. To achieve that growth economic and monetary policies that are more expansive will have to be agreed upon among at least Germany, the United Kingdom, Japan and the United States. In addition, a stabilization, within realistic limits, of the main world trading currencies is a necessity.

Since the demise of Bretton Woods in 1971, we have replaced a fixed-rate exchange system which had many problems, but produced extraordinary growth, with a floating rate system with even greater problems. The wild swings in currency rates, often due to purely speculative movements of capital, have turned financial theories upside down: Instead of having trade patterns affect currency rates, currency rates are now affecting trade patterns. The weakness of the yen is ludicrous in the light of Japanese exports flooding the world and a domestic inflation rate of 5 percent. The automatic reaction to this situation is protectionism, no matter how ultimately counterproductive it may be.

I believe the time has come for much closer, institutional ties between the main European currencies together with the dollar and the yen. A 1983 version of the Bretton Woods Conference should provide a framework to decide among various options. These would include stated commitments by the respective central banks to maintain currencies within agreed upon ranges, coordination of monetary policies, possible expansion of the European Monetary System to include the dollar and yen, expanded swap arrangements, etc.

Simultaneously, the issue of debt stretchout should be considered. Many debtor countries, today, have debt service payments of more than 100 percent of export earnings. The current rollovers are not attenuating the problem sufficiently and, asking the banks to provide new credits to borrowers choking on the old ones, is not really helping either the lenders or the borrowers. In looking at this problem, we should be realistic about substance and worry about form (i.e. bank accounting) later.

The reality of the situation is that a significant part of the $700 billion presently loaned to the Third World and Eastern bloc will only come back over a very long period of time, if ever. Instead of maintaining the fiction that these are short-term, high-interest loans, and asking the banks to increase their commitments, it might be better, both for lenders and borrowers, to create a mechanism which would stretch existing loans out to 25–30 years, at much lower interest rates. If, for instance, $300 billion of existing short-term credits were stretched out to 25 years or 30 years, with an interest rate of, say, 6 percent, this would provide enormous, immediate relief to the borrowing countries without changing the economic reality of these credits. The savings on interest costs alone, could amount to $15–20 billion annually and would reduce the current pressure for additional credits from an overstretched banking system. Together with the remaining short or medium term debt, the schedule for principal repayments could be tailored, country by country, in such a way as to reduce debt service costs to 25–30 percent of exports.

I am aware of the fact that such a program involves the recognition of significant costs and losses; a 25-year 6 percent loan is worth considerably less, on its face, than a short-term 13 percent loan. The allocation of such cost, as between bank stockholders, taxpayers and countries, would be the subject of a difficult negotiation. However, if successful, there would be daylight at the end of the tunnel.

The present approach of combining IMF austerity programs while keeping the borrowers under continuing crushing debt-service pressures could be self-defeating. Unless a strong, world-wide recovery were to occur soon (which seems unlikely) the potential for social and political radicalization will become greater and greater.

The mechanism for such a stretchout will not be difficult to determine once it is decided on how to allocate the costs. A subsidiary of the World Bank or the IMF, or a totally new institution, guaranteed by various governments, could acquire the banks' credits in exchange for long-term, low-interest bonds of its own. The new entity would become the substitute creditor, on the same long-term basis, to the present borrowers. The banks would suffer loss of income, but due to the greater safety of the credit, could be permitted by their regulators to maintain their balance sheets intact or schedule limited writedowns over a long period of time. It would be difficult, but it is certainly feasible. It would provide a long-term, viable economic resolution which has to be the ultimate objective.

Certain subsidiary questions have to be raised. Should there be a change in some regulatory aspects of the banking system? Clearly the concept of aggregate country risk should be included in the legal lending limits of American banks. What percentage of a bank's capital can be exposed in any one country should be the subject of debate, but there has to be a reasonable limit. Other changes in regulation, appropriate reserve ratios, evaluation of assets, will undoubtedly be the subject of further examination.

Should commercial banks lend to foreign governments on a long-term basis, or should this be handled on a government-to-government basis? This is a difficult question and has to be examined. I would argue that, in the case of Communist governments such as Eastern Europe and the Soviet Union such credits are of strategic value and should be handled government-to-government. They should become a part of our strategic negotiations with the Soviet Union. There are presently over $80 billion of credits outstanding to Eastern European countries and the Soviet Union; they have to be rolled over and substantial additional credits provided over the next few years. Estimates have been made of another $40–$50 billion of new credits needed over the next 5 years. We should, together with our European allies, propose a long-term re-financing plan for Eastern Europe in which the Soviet Union would join us and would provide half the credits and assume half the commitments. We should withhold rescheduling past debts, much less providing new credits, in the meantime. If this means a bankruptcy of Poland in the meantime, I would take this as an acceptable cost and our respective central banks can insure the viability of the banks involved, mainly the Germans. In a general sense, long-term loans are not the province of banks but, rather of insurance companies and the public markets. If loans to foreign governments, by definition, are long-term loans, it seems to me to raise a fundamental question.

One last question concerns OPEC. The Western democracies are now paying for the third time the OPEC price increases of the 1970's. We paid directly by transferring hundreds of billions in price increases. We paid indirectly by the resulting inflation. We are now paying, for the third time, by, one way or another, paying off the debts of the Third World countries which were originally entered into to pay for oil. OPEC may have less cash flow than it had two years ago, but their wealth and their credit is ample. This wealth must be mobilized to help in this refinancing effort. OPEC has enough at stake in the well-being of the West, and we have enough combined leverage militarily and politically, to bring about such a negotiation.

I apologize to the Committee for having drifted far from the original question. I believe, however, that the issues I have raised are relevant to your basic deliberations about increased U.S. support to the IMF. I support such increase, inequivocally. However, I am convinced that, basic to any long-term resolution of the current world debt problem, are:

(*a*) Coordinated, aggressive economic growth policies among western nations;

(*b*) An orderly international monetary system whereby the main trading currencies are maintained within given ranges;

(*c*) A long-term, low-interest, refinancing of a significant part of the world-debt;

(*d*) Participation by OPEC and the Soviet Union in the financial burdens of such an approach;

(*e*) Maintenance of liberal trade policies throughout the world.

I am not naive enough to think that this is an easy program. It requires political leadership and vision of a high order, beginning with the United States. So did the Marshall Plan, NATO and Bretton Woods. However, only a world-wide program can solve a world-wide problem. There are obviously many variations to this theme; I see no acceptable alternative to the concept. The United States, Europe and Japan must, jointly, lead the world back to prosperity.

Senator MATHIAS. Thank you, Mr. Rohatyn.

Mr. Cline?

STATEMENT OF WILLIAM R. CLINE, SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, D.C.

Mr. CLINE. Thank you, Mr. Chairman.

Of the $500 billion owed by developing countries today—or $700 billion if one includes Eastern Europe and short-term debt, approximately $375 billion is owed to private banks.

There are two debt problems today. The first is that the inability to service this debt could cause bank crises and international monetary crises.

The second is that debt servicing difficulties can slow the growth in developing countries, reduce the exports from industrial countries to developing countries, slow the growth in industrial countries and contribute to worldwide recession.

The problem stems from higher oil prices in 1973-74 and 1979-80, and from higher interest rates in 1981-82 in particular. The real interest rate on LIBOR lending, that is deducting inflation, went from a minus 2 percent in 1973-77 to a plus 11 percent in 1981-82. Every 1 percentage point increase in interest rates costs the developing countries $3 billion in debt service.

Global recession has also been a cause, with lower commodity prices and collapsing export markets. Domestic policies have been part of the problem. Argentina and Chile maintained highly unrealistic exchange rates. Mexico failed to adjust.

More generally, there has been a shift from world inflation to world disinflation. And in this environment the debt no longer is cheap. And finally, there has been a structural flaw in the lending process with an over-reliance on medium-term development projects.

Psychology, in addition to economic causes, has been crucial. The shocks of near default in Poland, of Argentina's debt disruption, and particularly of Mexico's suspension of payment in August, spilled over into international capital markets causing a drying up of loans to Brazil; a general cutback in international lending on an abrupt basis that has essentially precipitated the current crisis. To some extent, this cutback was inevitable because bank lending has been growing at 20 percent whereas bank capital has only been growing at 10 percent a year.

I would like to focus first of all on system stability. The underlying creditworthiness of developing countries has been eroding despite some indicators suggesting the contrary. The ratio of debt to exports has been relatively constant, but if one examines the debt service burden, that has been rising rather sharply. If one looks at the real debt service ratio, in other words deducting the inflationary erosion of the debt but otherwise considering the ratio of interest and the principal repayment to exports, that has risen from 9 percent in 1975-77, to 17 percent in 1981-82. Higher real interest rates, primarily as the result of U.S. monetary and fiscal policy mismatch, have been the driving force in this process.

A simpler way of looking at the extent of the problem is to list the countries that are in trouble. In table 1 of my written testimony you will see a listing of countries by the amount of their bank debt. And if one simply considers Argentina, Brazil, Mexico, Poland, Chile, and Yugoslavia—all of whom have had debt difficulties—more than half of bank debt held by developing countries is in jeopardy at this time.

To be sure, this bank debt could not possibly disappear overnight. On the other hand, a disruption could be a severe shock to the system. Consider the following possibility: If Argentina, Brazil and Mexico were jointly to miss 1 year's payment of principal and interest, and if they were to do so in a way whereby the banks were forced to write off those missed payments—which is unlikely but nevertheless not impossible, especially if banks reached the point where they are unprepared to make additional loans—then the result would be for the nine largest U.S. banks a loss of nearly $14 billion—and that is in 1 year. That may be compared with their 1-year profits of about $4.5 billion and their capital of about $27 billion. In other words, one-third of their capital would be wiped out.

The effect of that would be that the banks would have to reduce their exposure in other loans by a 16-to-1 multiple because of the leveraging of banks, and that lending would have to contract by about $150 billion—at least potentially—for these banks.

Senator MATHIAS. That is the point that Mr. Rohatyn was making, that they would not function normally.

Mr. CLINE. Yes; that is right.

Mr. ROHATYN. That is probably the understatement of the week, Senator. [Laughter.]

Mr. CLINE. It is crucial, then, to keep the largest debtors, the "super debtors" on tract. This includes at the least Brazil, Mexico, Argentina, Venezuela, and Poland.

Senator MATHIAS. I think you have just coined a word, the "super debtors."

Mr. CLINE. I will use it again. [Laughter.]

The recent measures have been encouraging. I will not rehearse the rescue missions but I will highlight one feature, and that is the role of the IMF in essentially coercion of new lending from banks. This is basically desirable because individual banks have an incentive to get out if they do not think other banks are going to come in. And by having a unifying factor it is possible to overcome that antisocial incentive. There is a dark side, however, which I think we have to consider. Will the banks in the future hold the Government responsible for potential future losses?

Now beyond that, despite the present calm, I would suggest that the risk is not past. In Argentina the political situation is highly volatile. In Mexico it will be difficult to meet the targets in the best of cases, and if there is a collapse in the price of oil—which is not impossible—the results would be devastating. In Brazil there is a strong likelihood that the balance-of-trade targets in the IMF package will not be met. And it is fairly likely that both Mexico and Brazil will have to return in mid-1983 for more money. Who will lend it?

The banks are at their limits and the IMF is already at its ceiling for lending to Mexico and Brazil. More fundamentally, if we get through 1983—I think the probability is still very good that we will without a severe crisis—a prolonged international recession could mean that Mexico, Brazil, and others decide by 1984 and after that the domestic growth sacrifices that they have to make to continue servicing their debt are not worth it. They are, in the cases of Mexico and Brazil, both likely to have a minus 2-percent growth or worse in 1983, and they may be unprepared to continue this for future years.

The second problem is, of course, the LDC growth problem. Essentially, one has a low probability-high cost risk of system collapse. But the other problem is a very high probability of a less dramatic cost problem of slower growth generally.

LDC growth has declined from 5 to 6 percent to 2 percent in 1981. The growth is going down, imports are going down. Morgan

Guaranty Bank has calculated that the $25 billion cutback in bank lending to developing countries which is now anticipated will cause a 1½ percentage decline in developing country growth, and that in turn will cause a reduction in exports from the industrial countries that will cause industrial country growth to decline by half a percentage point.

So, the second part of the problem—though less traumatic—is extremely painful and in a word it adds up to propagation of international recession.

Let me turn to policy. The first policy that we must follow is expansion in the industrial countries. And for this purpose I would refer you to a pamphlet put out by the Institute for International Economics reporting a policy statement by 26 economists from 14 countries which advocates a program of coordinated expansion on an international basis, emphasizing monetary policy in the United States and different mixes in other countries. We feel that there is little risk of reigniting inflation at this time with high idle capacity and high unemployment.

Second, reduction in the interest rate is crucial. We have had already some relief. The 5 percentage-point decline in interest rates will save perhaps $11 billion for the developing countries in 1983. It is important to try to get further declines in the interest rate.

Third, a less overvalued dollar is important. An overvalued dollar tends to depress the dollar prices of commodities and therefore the dollar value of exports to developing countries, while at the same time the dollar value of debt continues to rise.

Fourth, it is crucial that banks continue to lend. Expansion of 8 to 10 percent in their exposure to developing countries is essential.

Fifth, developing countries themselves have to adjust.

Let me focus on some of the policy measures affecting the International Monetary Fund. It is essential, in my view, to obtain the 50-percent increase in quotas for the International Monetary Fund—that is now generally agreed—and to establish the $20 billion emergency fund. The International Monetary Fund is really the key institution for guarding against international financial collapse.

Now, it is understandable that some Americans would ask, "Why put more money into the IMF or in the developing countries when we have high unemployment at home and when this will simply be 'bailing out' the banks?"

First of all, the reality is that an international financial collapse will cause far more unemployment inside the United States than we now have. To scrimp on the IMF is equivalent to a decision by a homeowner to save money by discontinuing the premiums on his fire insurance.

The cost is virtually negligible in budgetary terms. IMF quotas do not come against the budget. And in the case of the World Bank it would be possible to expand capital without requiring paid in, that could be callable capital.

On the charge of whether the IMF bails out the banks, we have heard—I think quite accurately—the IMF has been bailing in the banks with its historically new preconditions that the banks make new lending in the cases of Argentina, Brazil, and Mexico.

What about bank irresponsibility? If the banks were irresponsible, why does the public owe them anything?

I would submit that there are only a few cases—perhaps Zaire and Peru in the mid-1970's—where excessive, irresponsible lending is a case that can plausibly be made. On Brazil there is general agreement that the lending has been for sound development. Even in the case of Mexico there were signs at various points in early 1982 that policies were being changed, that perhaps the oil problem might be temporary. And it is only with the luxury of hindsight that it is easy to say that there was excessive or even irresponsible lending in Mexico. So I do not generally subscribe to the thesis of vastly irresponsible bank lending.

Policy measures should include an expansion of the World Bank lending and a change in World Bank policy toward much greater emphasis on structural adjustment lending for fast disbursement.

Other crucial changes are the following: Even if quotas are increased by 50 percent in the IMF, and even with a $20 billion emergency fund, IMF resources may prove to be too small. We should be prepared to support IMF borrowing in private capital markets and from individual governments such as Saudi Arabia. In addition, the IMF must be prepared to go beyond its own internal ceilings on lending to individual countries, in the cases of the "super debtors" that must be kept on track if the system is not to be in severe jeopardy.

That means in the middle of this year, for example, if Mexico and Brazil need more funds and the banks are not prepared to provide them, then even though the IMF is already at its ceiling with respect to these two countries it should be prepared to exceed the ceiling. For this purpose, the new emergency fund is the logical vehicle.

What about more radical policy changes? There has been some talk about the need for a new institution to bridge countries over from the time they get into trouble to the time that they have an IMF agreement. I consider this a red herring. It is basically a problem that concerns the "super debtors" on a case-by-case basis. Other countries are too small to affect the system and can be safely allowed to go into arrears until an agreement with the IMF is reached.

Some have proposed a general moratorium. This is completely infeasible. It would be devastating to the banks as even the calculations for a 1-year moratorium in the case of the major debtors would illustrate.

The possibility of an official intermediary such as the World Bank or the IMF buying up bank debt at 90 cents on the dollar and taking over LDC debt, may be worth considering as a contingency. But I would point out that it would require very high capital contributions and guarantees, and that we have to consider whether the public is prepared to make such contributions at this time.

More generally, any sweeping reform runs the risk of continuing the guilt-by-association that has already caused too much trouble.

It seems to me that we should conceptualize the current situation as a need to return to a voluntary capital flow process, and I think we have a good chance of doing that. We must remember that the large banks want to be in countries like Brazil and Mexico over the longer term. We are not in a situation where we have gone from day of voluntary lending to night of never any voluntary lending in the future.

It is not clear to me at all that we want across-the-board reforms that are going to insure that voluntary lending does not happen in the future.

Other reforms I would suggest would include the tightening of lender-of-last-resort coverage—as the Banco Ambrosiano problem illustrates. In the longer run, we need tighter prudential treatment of rescheduled loans—although that would be counterproductive at the moment because it would further discourage bank lending.

And in the longer run it is crucial, it seems to me, to reduce bank exposure to developing countries as a fraction of their capital. The Western financial system now is too vulnerable to developing country debt.

This objective will require either more official lending which will be difficult, or the development of new vehicles for capital flows to developing countries. Direct foreign investment can play some role and conceivably increased borrowing on the bond market can help.

Replacing the banks as the principal vehicle for capital flows to developing countries will be the principal international financial challenge of the 1980's.

Of all of these policies, let me return to what I think is the most fundamental, and this is expansionary policies to reactivate the international economy.

Thank you.

[Mr. Cline's prepared statement follows:]

Prepared Statement of William R. Cline

EXTERNAL DEBT AND GLOBAL FINANCIAL STABILITY

The external debt of non-oil developing countries today stands at over $500 billion; the total is approximately $700 billion if short-term debt and debt of Eastern Europe are included. Commercial banks account for $375 billion of this total. Total debt of these countries has multiplied approximately six-fold from 1973, and nearly tripled in real terms. Today there are essentially two components to the debt problem. The first is that a breakdown in the orderly servicing of this large debt could cause severe pressures on private banks and the international financial system. The second is that the need for developing countries to cut back on imports in order to meet heavy debt payments in the face of shrinking supply of new bank lending may cause sharp reductions not only in their own economic growth but also in that of industrial countries that export to them.

World credit markets have suffered the shocks of near default in Poland, debt servicing disruptions in Argentina since the Falklands War in the spring of 1982, a dramatic suspension of principal payments by Mexico in August of 1982, and an exremely severe liquidity crisis in Brazil at the end of 1982. Because these four countries include the largest outstanding debts, the threat to the system has been substantial. For the present at least the crises seem to have been overcome. For Mexico, Brazil, and Argentina the official and financial communities have mounted successful rescue operations involving emergency lending from the U.S. Treasury and other central banks, country agreements with the International Monetary Fund involving not only new loans but also commitments to domestic adjustment, and coordinated packages of lending from the private banks. But the system is by no means out of danger, and the current breathing space should be used for the design of a longer run policy capable of dealing with possible renewed threats in the future.

ORIGINS OF THE DEBT PROBLEM

The large amount of external debt owed by developing and Eastern European countries stems from three central economic forces; the recent erosion in the viability of that debt is in addition influenced by psychological factors. The economic causes of the debt problem have been the sharp rise in oil prices in 1973-74 and again in 1979-80; the extremely high level of interest rates beginning in 1979;[1] and the global recession of 1980-82. Because of higher prices oil imports have risen from 6 percent of imports of net oil-importing developing countries in 1973 to 20 percent today. Because of higher interest rates, caused largely by the mix of tight money and loose fiscal policy adopted in the United States in 1981-82, the average interest rate on outstanding long term debt rose from 4.5 percent in 1973-77 to 8.5 percent in 1981-82; deducting (U.S.) inflation the real interest rate rose from −6 percent to +3 percent over the same period.[2] The bulk of external debt bears interest rates that fluctuate with international interest rates; one percentage point increase in interest rates now costs developing countries over $3 billion in additional debt servicing (net of extra earnings on foreign exchange reserves). For its part, global recession has driven down commodity prices to the lowest real levels since the depression; it has cut back growth of export markets in industrial countries, and the special economic crises of countries such as Nigeria and several Latin American countries have devastated the new markets for manufactured exports to these countries from such newly industrialized countries as Brazil.

Higher oil prices, higher interest rates, and world recession are all external causes of high debt, but there have also been domestic causes. Brazil consciously chose a high-risk, high-growth strategy that depended on rapid debt build-up; Argentina and Chile held on to an overvalued exchange rate that caused debt to mushroom; and Mexico failed to adjust to a much softer market for its oil exports, running up huge budget deficits rather than make painful cuts before an election. Nonetheless, most careful studies indicate that the bulk of borrowing by developing countries has gone for productive investment.[3]

A broad theme of the debt problem is that there has been a sea-change in the world economic environment from inflation to disinflation, making borrowing decisions that seemed prudent in the late 1970's look risky in retrospect as real interest rates—the true cost of borrowing—have risen sharply just as recession has shrunk export markets. Thus it is basically a change in international economic conditions rather than a record of irresponsibility either on the part of the banks or on the part of the developing countries that has made the international debt situation so precarious.

In addition, today's problems stem from the structural inadequacy of capital flows since the mid-1970's. Developing countries relied increasingly on private bank flows, primarily because official flows did not rise fast enough to keep pace with borrowing needs. For a time analysts and policy-makers congratulated the private financial markets for rising to meet the challenge posed by the oil-finance recycling problem, but in retrospect it is all too clear that this response not only made the developing countries too dependent on short- and medium-term loans to finance long-term development projects, but it also made the banking system in industrial countries too dependent on sovereign risk. The mismatch between the maturity of lending and that of development projects caused no problem as long as bank confidence permitted rollovers of previous loans, but as became painfully clear in the last few months, as soon as that confidence faltered that heavy reliance on private bank lending of short and medium maturity caused a severe squeeze because rollovers were no longer automatic.

Bank confidence has indeed suffered a severe reversal. It is striking that the initial phase of this reversal was highly political: the Polish and Argentine debt disruptions were precipitated by political events with international dimensions. The most extreme shock to confidence came from the Mexican disruption, which resulted primarily from economic and domestic political causes combined with a run on the peso made possible only by Mexico's commitment to free exchange convertibility, a rarity among developing countries. By September 1982, the damage to confidence had been done. Loans to Brazil began to dry up. Although there was some further erosion in economic creditworthiness of Brazil and other developing countries in 1982, largely because of declining exports, I would say that the greater part of the debt problem for Brazil and several other countries is now attributable to the psychological erosion of private bank confidence, whereas fundamental economics is responsible only to a limited degree. If 1982 could be rerun without the Mexico crisis, Brazil would very probably have experienced no borrowing difficulty. In a word, the banks overreacted.

---

[1] High nominal rates in 1979-89 were offset by inflationary erosion of debt, although the result was a cash flow squeeze (the benefit of debt erosion was in the future but higher interest payments were immediate). But by 1981-82 interest rates were extremely high in real terms as well; there was little inflationary erosion of debt to compensate for high interest rates.

[2] For funds borrowed commercially at a typical rate of LIBOR (London Interbank Offered Rate) plus 1 percent spread, the corresponding rise was from 8.8 percent to 16.8 percent, in nominal terms, and from −1.6 percent to 11.3 percent in real terms.

[3] Jeffrey D. Sachs, "The Current Account and Macroeconomic Adjustment in the 1970's," Brookings Papers on Economic Activity (1:1981, pp. 201-68).

In some sense this reaction was probably inevitable. Bank exposure to non-OPEC countries has been growing at 20 percent annually since the late 1970's, but bank capital has only been growing at 10 percent. In 1982 the rate of new bank lending fell by perhaps half (final data are not yet available)[4] and annual new lending at only half the 1981 rate (approximately $20 to $25 billion instead of $50 billion to non-OPEC developing countries), or even less, is widely expected to be the new rate for the near term. This sharp cutback has been driven by the reversal in bank psychology. At least to some extent it has the features of a classic panic or financial bubble, whereby the "manic" phase of rapid expansion gives way at some point, usually upon some specific signal such as a business failure, to a phase of panic.[5] For the world credit markets, the Mexican crisis was the signal marking the critical turning point.

SYSTEM STABILITY

To examine the first aspect of the debt problem—the risk to the international financial system—it is necessary to begin with a stock-taking of the extent of erosion of LDC creditworthiness. Ironically, by some measures the erosion has been limited. The ratio of external debt to exports for non-oil developing countries remained approximately constant at 100 percent from 1975 through 1981, although it almost certainly rose in 1982 with the decline in the dollar value of exports. However, because of rising interest rates the ratio of debt service (interest and principal) to exports of goods and services rose from 15.2 percent in 1975–77 to 26.6 percent in 1981–82 (including interest on short term debt). Deducting for inflationary erosion of debt, the rise in the "real" debt service ratio was even sharper: from 8.7 percent in 1975–77 to 16.8 percent in 1981–82.[6]

A catalogue of major debtors provides even more direct evidence of erosion. Table 1 lists the 20 largest borrowers of external bank funds. One year ago Argentina, Mexico, and Brazil had not experienced debt servicing disruptions; now they have. Together with Poland, Chile, and Yugoslavia, which have also had debt servicing suspensions or face severe servicing difficulties, they account for 58 percent of bank debt owed by the 20 largest debtors among the developing countries and Eastern Europe. Considering that some smaller countries such as Costa Rica are also in trouble, somewhat more than half of the total bank debt of developing and Eastern European countries now stands in some jeopardy over the near term. This calculation omits other countries even though they have high debt service ratios: Venezuela and Colombia because of unusually high foreign assets, and the Philippines and Malaysia because they are geographically removed from the Latin American sphere of current psychological contamination in credit markets.

---

[4] After rising by $47 billion 1981, developing-country exposure of the Group of 10 banks monitored by the Bank for International Settlements rose by only $16.8 billion in the first half of 1982, probably declined in the third quarter, and probably rose only moderately if at all in the fourth quarter. For Latin America, total capital inflows fell from $42 billion in 1981 to $19 billion in 1982; CEPAL News, January 1983.

[5] Charles P. Kindleberger, "Manias, Panics, and Crashes: A History of Financial Crisis" (New York: Basic Books, 1978), Ch. 2. In this case the object of the bubble is financial assets in LDCs, rather than shares in the South Sea Company or Dutch tulip bulbs.

[6] International Monetary Fund, "World Economic Outlook" (Washington, 1982), and special calculations of short-term debt from Bank for International Settlements data.

TABLE 1.—DEBT OWED TO INDUSTRIAL COUNTRY [1] BANKS BY DEVELOPING AND EASTERN EUROPEAN COUNTRIES, JUNE 1982

	Debt (billions)	Debt service [2] as percent of exports of goods and services
1. Mexico		
2. Brazil	$64.4	129
3. Venezuela	55.3	122
4. Argentina	27.2	95
5. South Korea	25.3	179
6. Poland	20.0	53
7. Chile	13.8	NA
8. Philippines	11.8	116
9. Yugoslavia	11.4	91
10. German Democratic Republic	10.0	46
11. Algeria	9.4	NA
12. Hungary	7.7	39
13. Indonesia	6.4	NA
14. Nigeria	8.2	27
15. Taiwan	6.7	20
16. Israel	6.4	21
17. Colombia	6.1	NA
18. Egypt	5.5	94
19. Malaysia	5.4	48
20. Peru	5.3	90
	5.2	48
Subtotal	311.5	
Total, LDCs [3] and Eastern Europe [4]	374.9	

[1] Group of 10.

[2] Including short-term principal.

[3] Including Yugoslavia; excluding Middle-Eastern capital surplus oil exporting countries.

[4] Excluding U.S.S.R.

NA = Not available.

Source: Bank for International Settlements and World Financial Markets, October 1982.

Obviously not even half of bank loans to these countries will disappear over night. Even if forced to interrupt payments, countries can reschedule debts, avoiding bank write-offs; and even if reschedulings come unglued, banks would only have to write-off a fraction of loans—not the full amounts—corresponding to the payments missed, except in the politically unlikely event of a formal debt repudiation. Debt failures occur in slow motion.

Nevertheless, a temporary but severe disruption of debt servicing could be costly to the banks and to stability of the financial system. At the moment, Mexico, Argentina, and Brazil are on track with debt restructurings of varying degrees of formality. But consider what would happen if all three missed just one year's payment of principal and interest and did so in a form of involuntary moratorium that did not qualify as a bonafide debt rescheduling and whereby the payments missed could not plausibly or prudently be maintained on the books of the banks. A 1-year moratorium on interest and principal by Argentina, Brazil and Mexico would cause losses equal to one-third of the capital of the nine largest U.S. banks even after taking account of offsetting profits on other loans.[7] While this cut in capital would not cause insolvency—except perhaps for one with heavy domestic losses as well—it would mean that the banks would have to begin to reduce their total loans sharply in order to reestablish the 6 percent capital ratio to loans required by regulations. There would thus be a multiple reduction in loans. Potentially the nine largest banks would have to cut their loans outstanding by approximately $150 billion as the result of a loss of one-third of their capital from 1 year's loss of principal and interest from Argentina, Brazil and Mexico under conditions where these losses had to be written off. Even if the Federal Reserve loosened the capital backing of loans temporarily, the potential would exist for economic shock waves through reduced credit availability to American business and more unemployment. And Argentina, Brazil, and Mexico are less than half of the problem. Loans to these countries account for 113 percent of capital of the nine largest banks; loans to all developing countries and Eastern Europe account for approximately 250 percent of their capital. For all U.S. banks the ratio of loans to non-oil developing countries plus Eastern Europe stands at 160 percent, somewhat lower but not greatly so.

---

[7] These three countries owe $30.5 billion to the nine largest banks, whose capital broadly defined is only $27 billion. Together the three countries owe the nine largest banks approximately $3.4 billion in interest, $6.9 billion in short term debt payments, and $3.4 billion in long term debt payments for 1983, before recent restructurings. The total owed is $13.7 billion for 1983. By contrast, 1981 profits of these banks were $2.8 billion net, or approximately $4.3 billion before taxes. Thus a loss of $13.7 billion would cause total losses of $9.3 billion, and without offsetting items generating taxes these losses would have to be fully absorbed out of capital.

So far the system has avoided this kind of international financial shock. From the standpoint of the global financial system it is crucial to keep a handful of the largest debtors from default: Brazil, Mexico, Argentina, Venezuela, and Poland. The system could absorb a number of defaults by smaller debtors, but default or moratoria by three or four of the largest could cause the kind of systemic shock just described. The sofar successful rescue packages for Argentina, Brazil, and Mexico are all the more important for this reason, and they give cause for encouragement. I need not rehearse the sequence of international efforts by central banks, and the terms and magnitude of the IMF agreements, that have temporarily kept these three super-debtors on track. One feature, however, warrants highlighting. For the first time the International Monetary Fund has required private banks to increase their exposure as a precondition of lending programs, offering them the alternative of putting in new money or suffering country default on the old money. This change is of historical significance. There is a well known problem whereby each bank acting in isolation may be forced to try to take its money out if it thinks other banks will do so even if individually it would prefer to continue lending, and by acting as coordinator the IMF has reduced this problem of counterproductive action in isolation (although some of the smaller banks may still try to cut and run). There is an interesting question, however, of whether the IMF's coercion doesn't establish some bank claim to future public sector support, much as appears to be the case with respect to German banks' perception of government responsibility following public cajoling of additional lending to Poland.

The temporary success of keeping the super-debtors from default is by no means guaranteed to hold for the future. In Argentina the political fabric is so strained, in part because of the issue of "disappeared" civilians, that performance under the IMF agreement is in doubt, even though in purely economic terms Argentina's external balances are relatively promising. Mexico may have some political difficulty implementing its austerity plan, could fall short of balance of payments targets, and is subject to a possible drop in oil prices (in today's weak market) that would completely unravel the financial program. It is relatively likely that Brazil will be unable to fully meet its ambitious plan to raise the trade surplus, and that as a result it will have to return in mid-1983 to ask the banks to provide additional new money beyond the amount already coaxed out of them by the International Monetary Fund. More fundamentally, if the international recession does not turn into recovery soon, the choice for Mexico and Brazil by 1984 could be between accepting further, austerity-induced loss of income on the one hand and some form of debt moratorium on the other. The longer the international recession, the greater the cumulative domestic income loss, the more likely an eventual political decision in favor of moratorium. To complete the picture of downside risk, it is not clear how far the banks are prepared to attempt to rescue old money by adding new. The 121 largest international banks lending to Brazil have been asked (and to date most have agreed) to increase exposure by $4.4 billion in 1983, or by 12.5 percent, a rate already in excess of capital growth; how much more will they be prepared to add?

In all of the recent major debt crises there has been a disturbing trend toward involuntary or forced rescheduling. Mexico unilaterally announced postponement of principal in August; late in the year Argentina unilaterally announced medium-term postponement of payment of approximately one-third of its private debt in so-called "swap" accounts (that had entered the country with favorable guarantees that were perhaps implausible even from the start). Brazil, which has intensely tried to distance itself from the temporary debt suspensions of Mexico and Argentina, took a step toward rescheduling on a basis that was involuntary to banks when, after announcing plans to postpone 1983 principal but before obtaining bank agreement, it unilaterally announced these payments would be postponed.

There are two basic problems in this gradual slide toward rescheduling on a basis that is involuntary to the banks. First, for Brazil especially, postponement of principal is not adequate given the wide gap between export earnings and imports plus heavy interest payments. Instead, large continued infusions of new lending are required to close the external accounts. And if Brazil moves more completely to a formal rescheduling whereby bank rollovers are involuntary, the result will be to dry up badly needed new lending even more completely, leaving no alternative but the arm-twisting of involuntary new lending to cover interest (along the Polish model). The second problem with this trend is that it makes maintenance of full value of rescheduled loans on the books of the banks more suspect. As an agenda item for longer term reforms, even rescheduled principal with servicing of interest should probably be subject to some loan provisioning because of the inherent evidence that the original loan is not meeting expectations; when even the interest is paid essentially through involuntary new loans, nonprovisioning becomes even more suspect.

DEVELOPING COUNTRY GROWTH

From the standpoint of global stability the international financial system at least for now has avoided the shock of default by the superdebtors, although there is ample cause for concern about the eventual outcome of the rescue package. On the second dimension of the debt problem, developing country growth, the record is more uniformly negative. There is low probability and very high cost of a world financial collapse caused by LDC debt; there is high probability albeit less dramatic cost of a slowdown in LDC growth caused by the debt burden. Non-oil developing countries achieved average growth of 5 to 6 percent in the late 1970's (when industrial countries were growing more slowly), but finally world recession and debt burdens cut their growth to only 2.5 percent in 1981, and for 1982 the results were even worse. For Latin America real production grew only 1.5 percent in 1981 and actually fell by approximately 1 percent in 1982. Despite official statements to the contrary, adjustment programs in Mexico and Brazil are highly likely to reduce output by 2 percent or more in 1983. More generally, as developing countries cut back imports to deal with stagnant export markets and declining capital inflows, their growth can be expected to fall.

Morgan Guaranty Bank has estimated that the halving of new bank lending anticipated will cut developing country growth by 1½ percentage points, and that the induced reduction in industrial country exports will cut growth in industrial countries by one-half percentage point.[8] These estimates are more probably overstated than understated, but they are on the right order of magnitude. In a word, the crisis of confidence in bank lending is contributing substantially to global recession. And, with 32 percent of its exports going to the non-oil developing countries, the United States will suffer reduced growth as the side-effect of LDC cutbacks caused by the crunch in external financing.

The IMF has been criticized for recommending austerity policies that involve reduced imports and income in individual countries, while failing to add up the consequences and realize that it spells global recession. But adjustment is required in developing countries, with more slowly growing imports and more rapidly growing exports. The missing element in the global equation is more rapid economic growth in industrial countries, so that LDC export expansion is feasible and that the global sums are not negative.[9]

Whether there will be a quiet crisis of slower LDC growth as the result of debt and financing difficulties is not in dispute: it is already occurring. The only questions are how severe this quiet crisis will be, and whether it will be accompanied by the more dramatic wrenchings of a global financial crisis. The answers will hinge of public policy.

POLICY IMPLICATIONS

Reactivation of the international economy is by far the most important policy instrument for dealing with the problem of international debt. Faster growth in industrial countries would mean more buoyant markets for developing country exports as well as some recovery in commodity prices. I radically disagree with those who argue that inflation is the only way out of the debt problem. Another wave of rapid inflation would merely raise world interest rates on LDC debt and make a subsequent recession even more severe. Fortunately, there is now ample room for more expansionary policies in industrial countries without re-igniting inflation. Industrial capacity utilization is extremely low, unemployment is at record highs for the postwar period, and grains are in excess supply. In the United States a continuation of the recently more expansive monetary policy, with the goal of bringing interest rates down by perhaps another 2 percentage points, is essential; and while fiscal policy needs to be tightened for later years, for the next year tightening would be undesirable. In other countries differing mixes of policies are desirable; but overall what is needed is an internationally coordinated move to more expansionary policies to bring the world economy out of the most devastating recession since the 1930's.[10] Unless this international economic reactivation can be achieved, the likelihood is substantial that sooner or later major debt moratoria and financial crises will arrive.

---

[8] *World Financial Markets*, October 1982.

[9] In this context, there is some inconsistency in the IMF prescriptions insofar as they have systematically continued to emphasize restrictive policies in industrial countries in addition to austerity measures in developing countries. For a statement of the need to consider global economic conditions in IMF programs, as well as an analysis of the need for increased IMF quotas, see John Williamson, *The Lending Policies of the International Monetary Fund*, Institute for International Economics, Policy Analyses in International Economics No. 1, August 1982.

Lower interest rates are especially crucial for overcoming the LDC debt problem. The decline of approximately 5 percentage points in United States and Eurodollar interest rate in the last 6 months will provide some much needed relief; if rates stay at current levels, developing countries should have a reduction of approximately $11 billion in their interest payment in 1983 (taking account of a higher debt base and lower earnings on reserves), offsetting perhaps one-third to one-half of expected cutback in bank lending. It is imperative that this decline in interest rates be maintained and, if possible, pushed considerably further.

A less overvalued dollar would also contribute substantially to improvement in the debt situation. The overvalued dollar has tended to reduce the dollar price of commodities, and raise the ratio of largely dollar-denominated debt to the dollar value of exports. In addition, many developing countries tie their exchange rates to the dollar, so that overvaluation of the dollar causes an additional stimulus to their imports and causes depressant to their exports.

It is also crucial that the private banks continue to lend new funds to the developing countries. For the near term an appropriate target for expansion is probably 8 to 10 percent of exposure, more in line with capital growth than the heady expansion of the late 1970's but a positive growth that avoids the likely financial crises that would result from attempts to freeze or even reduce exposure. The regional banks and some European banks have shown more reluctance to continue lending than the largest U.S. banks, primarily because individually they view themselves as too small to precipitate a crisis by their own action. It is important that these smaller banks continue to lend along with the larger banks, because in the aggregate they are large enough to make a great deal of difference.[11] Public authorities can facilitate continued lending by their regulatory decisions on loan status and in some cases by moral suasion. The IMF should continue its new approach of encouraging banks to continue lending in particular stabilization programs.

For their part, the developing countries should pursue adjustment programs, typically emphasizing more realistic exchange rates, lower budget deficits, and less reliance on external borrowing. They should seek maximum emphasis on efficient shifting of resources toward production of exports and import substitutes, as opposed to general recessionary reduction in resource utilization, in order to achieve external adjustment at the lowest cost in terms of real output. Typically this process will require labor cooperation in the setting of real wages so that devaluation is not frustrated by a wage-price spiral.

At the international level it is essential that IMF resources be increased by at least the 50 percent now under consideration, and that in addition the "emergency fund" of $20 billion in the General Arrangements to Borrow with the IMF also be established. It cannot be emphasized too strongly that at the present time the International Monetary Fund is the paramount vehicle available for ensuring that sovereign debt problems do not lead to international financial collapse.

It is perhaps understandable that some Americans question increasing IMF resources, or other lending to foreign countries, when unemployment at home is so high, and when there is considerable suspicion that such measures merely serve to "bail out the banks." The reality, however, is that is there is no safeguard in the system against international financial collapse, there could be far more unemployed on America's streets. Even the limited moratoria I have outlined for Argentina, Mexico and Brazil could imply a sharp increase in U.S. unemployment.

---

[10] See Institute for International Ecomomics, *Promoting World Recovery: A Statement on Global Economic Strategy*, Washington, D.C., December 1982.

[11] Thus, while the 9 largest U.S. banks account for 58 percent of loans to Latin America, the smallest 143 of the 167 banks covered by Federal Reserve reporting account for 22 percent. Federal Reserve, County Exposure Lending Survey, June 1982.

Essentially the IMF provides insurance against world financial collapse. Just as it is the worst form of false economy to cut the household budget by discontinuing premiums on fire insurance, it would be seriously misguided to economize by failing to maintain adequate international financial insurance.[12]

With respect to the fairness of bailing out the banks, the first point to consider is that with the new IMF policy the banks are being forced to take up their fair share of the burden; the IMF is "bailing in" the banks. The more fundamental point is that the banks are such a strategic foundation to the economy that a severe blow to the banks cannot help but injure the entire economy.

A related critique is that measures to bail out the banks are misguided because the current problem is the result of their irresponsible lending, and that they should be made to pay the penalty for that irresponsibility. Aside from some isolated cases, however, such as those of Zaire and Peru in the 1970's, it is difficult to identify bank irresponsibility. Consider Brazil. Almost no one would argue that its massive debt is the result of irresponsible overlending by greedy bankers to an incompetent regime. Instead, there is general agreement that Brazil's policies have generally warranted the bank lending it has received. Even in Mexico the softer oil market was initially seen as temporary, and devaluation early in 1982 was a sign of positive policy reform; overlending by banks to Mexico is a critique that requires the advantage of hindsight.

In short, it is essential to raise the resources of the International Monetary Fund, and this measure should not be thwarted by naive arguments that our resources should be kept at home or that the government should not bail out the banks. A parallel line of action would be to expand the lending capacity of the World Bank and other multilateral banks. For this policy to have much impact on the current debt situation, however, it would be necessary for these institutions to become much more flexible in their own internal practices in moving toward fast-disbursing "structural adjustment" loans rather than keeping the bulk of their lending in project loans that require several years for actual disbursement.

There are other changes in the system that may also be required. Even with a 50 percent quota increase, IMF resources may prove inadequate. If so, or if the need arises before the increases are implemented, the IMF should be encouraged to borrow the required funds from private capital markets or from individual offical lenders (as has been done in the past in IMF borrowing from Saudia Arabia). Similarly, there must be flexibility at the country level in IMF lending. If one of the key super-debtors is unable to meet initial balance of payments targets it may be necessary for the IMF to lend additional amounts above and beyond the current limit of 450 percent of IMF quota. The logical vehicle for this purpose would be the newly expanded General Arrangements to Borrow; if it is to be a truly effective "emergency fund" it should be fully flexible. The basic point is that it is crucial to the system to avoid moratorium by a super debtor, and as the IMF is essentially the lender of last resort in the system it must be prepared to go beyond traditional norms if the situation requires it.

With this broad set of policy guidelines, it should be possible to navigate the dangerous waters of the next 2 or 3 years. Essentially this strategy is one of case by case treatment of debt problems with willingness on the parts of the industrial country governments, the IMF, the developing country in question, and the private banks to act forcefully to meet the evolving situation.

An alternative approach would be to pursue much more radical change on the basis of the argument that the external debt of developing and the Eastern European countries is clearly unsustainable and that substantial portions of it must somehow be written off and/or absorbed by official institutions. A mild reform that has received some attention would be to create some new vehicle or institution to bridge the period between the country's imminent difficulty and the reaching of agreement on IMF lending. In my view, not much energy should be spent on this problem. From the standpoint of the system it is only of significance for a few super-debtors, and they can be (and have been) handled individually; other countries can simply be allowed to go into arrears temporarily, because their individual debts are too small to affect the system.

More radical proposals include some form of generalized moratorium for a period of years. The calculations I have presented earlier for a 1-year moratorium just by Argentina, Brazil, and Mexico should be sufficient to demonstrate that any generalized moratoriums could be devastating to the banks and to the international financial system.

---

[12] And in budgetary terms there is no cost from increasing IMF quotas.

Another proposal has been that the IMF, World Bank, or perhaps some new institution wuld purchase LDC debt from the private banks at a discount—perhaps 90 cents on the dollar— and become an intermediary between the banks and the developing countries. This approach warrants consideration, but it would involve very high capital contributions or guarantees to the intermediating agency in order that it have the credibility to be able to issue reliable paper to the banks in exchange for their claims on developing countries. If the full amount of outstanding loans were "funded" in this way, instead of just annual payments coming due, the capital requirements could be huge.

A general problem with any sweeping reforms such as these is that they would indiscriminately lump together all developing countries as equally uncreditworthy, whereas many countries (especially in Asia) still have the capacity to maintain orderly debt servicing on their own. There has already been too much guilt by association in international lending, as Mexico's crisis spilled over to much of Latin America and Poland's to Eastern Europe; it could be a mistake to institutionalize the phenomenon by approaching LDC debt on a sweeping, multi-country basis.

There are other system reforms that do require close attention. The Banco Ambrosiano affair is another piece of evidence that more complete "Lender of Last Resort" coverage is necessary in the banking system. All offshore centers could require that parent banks accept legal responsibility for their subsidiaries. In addition, in the long run it would be desirable to have tighter prudential treatment of rescheduled loans requiring some provisioning of these loans. There is a short run conflict here with the objective of keeping new lending moving to developing countries at the present time, however. Also over the longer run it would be desirable for the system to reduce the exposure of banks to sovereign risk relative to their total capital. It is not prudent to have the entire U.S. banking system so vulnerable to default by a handful of developing countries. The central challenge in this longer term program is to develop an alternative vehicle for capital flows to developing countries, other than bank lending. The developmental need for these flows will exist for decades. But the sharp rise in bank lending as their vehicle was almost certainly an unsustainable historical episode of the 1970's. Now it is the turn of some other channel to take up a rising share. Recent experience suggests pessimism about the willingness of industrial country governments to return to greater reliance on official flows. Conceivably greater emphasis on the floating of bonds could be developed once capital market confidence has been restored, and more active flows of direct investment could also help. But the challenge of finding a replacement for bank lending will not be easy to meet.

In sum, an essential policy package for dealing with the problem of international debt includes reactivation of the world economy through internationally coordinated policies of expansion, lower interest rates, correction of misalignments of the dollar, continued bank lending, LDC adjustment, prompt adoption of the 50 percent increase in IMF quotes and the enlarged IMF emergency fund, perhaps expanded structural adjustment by the World Bank, and a willingness to deal with major threats to the system by allowing the IMF to borrow from private capital markets and to exceed its internal country lending ceilings if necessary. It would be counterproductive at this time to abandon this gradualist, case by case approach for sweeping reforms involving widespread moratoria or official refinancings of developing country debt. If the approach proposed here is followed, it should be possible to get through 1983 without major debt disruptions; but this relatively optimistic prospect cannot be expected to hold through 1984 and beyond unless the world economy recovers from its severe recession.

Senator MATHIAS. Thank you, gentlemen.

Let me start with a question of Mr. Rohatyn. You pointed to the possibility of a repudiation by one or more developing countries. Do you want to expand that thought any, as unhappy and grim as it is? Do you have any candidates?

Mr. ROHATYN. Unfortunately, Mr. Chairman, there are probably too many candidates. I mean, it does not really take a great leap of the imagination to think that if you have another year or 18 months, or 2 years of no growth, essentially and of rescheduled debt that simply keeps piling interest on top of debt——

Senator MATHIAS. Plus the rescheduling fees.

Mr. ROHATYN. Plus the rescheduling fees.

Senator MATHIAS. Fees.

Mr. ROHATYN. Plural yes, Senator.

Of what appears to, say, the average Mexican as IMF or foreign-bank imposed austerity and further reductions in standards of living to repay foreign banks—I mean, it would not take any great propaganda effort to create that image where it becomes both politically impossible to continue on this course and where it might become economically viable to even consider repudiation and live off your raw materials. I mean, Mexico has oil. Whether the price is $15, $20, or $25, it can probably live off its oil for a while.

And where both political and economic imperatives create a logic and a dynamic of its own, countries have repudiated their foreign debts in history.

I am not saying that this is likely, but it seems to me that on the scale of 0 to 10 it is not negligible. It is one of these things where maybe the risk is less than 50 percent, but if it happens the impact is devastating. And therefore I just do not think it can be overlooked.

Senator MATHIAS. As one component of this problem you have mentioned stabilization of exchange rates.

Mr. ROHATYN. Yes, Senator.

Senator MATHIAS. How do you do that without negating our concepts of free capital markets, free flow?

Mr. ROHATYN. You can have free-flowing markets, Senator, within the constraints of exchange rates that are not allowed to fluctuate beyond certain bands.

Senator MATHIAS. So you are talking about, really, stabilizing at the outer limits.

Mr. ROHATYN. Well, take the European monetary system where you have the so-called snake and where the various central banks maintain the limits of exchange movements to a certain band.

Senator MATHIAS. I never fully understood the snake, I must say.

Mr. ROHATYN. It is an arcane art, Senator, and I am not sure it is worth your while to really spend a lot of time on it.

But it would mean that there would be an agreement among the central banks not to permit the main trading currencies—the yen, the dollar, the pound sterling and the Deutsche mark—to go beyond certain limits without the central banks as a matter of fact intervening in the foreign exchange markets to maintain them there.

Now, what it does is require a commitment to intervention, which is philosophically now what the current thinking is. It also implicitly requires coordination of monetary policies, otherwise you have different kinds of problems.

But you do need something, it seems to me, to prevent a situation where the yen can be 280 to the dollar one day and 6 months later it is 200 because when those situations occur what it does is, it stops all industrial investment because you do not know where to put up your facilities and how to handle your commitments, et cetera.

I do not think that is a tolerable situation and I do not believe that you can talk rationally about industrial coordinated growth without addressing the problem of uncontrolled foreign exchange fluctuations. I just do not think it can happen.

Senator **Mathias**. I have a lot of interest in this particular part of the problem. But would your solution require a new financial institution, a new international association of some kind?

Mr. **Rohatyn**. I do not believe so, Senator. I think that there are enough mechanisms of cooperation among the various central banks and the international organizations presently existing so that that particular situation could be handled. It would simply require a commitment, swap arrangements, other arrangements among the central banks, and policies among the Western governments to make this happen.

I mean, tomorrow the Federal Reserve can go into the market and buy yen, and put the yen at 200. It may cost $10 billion, $15 billion, or $20 billion. It can be done.

Senator **Mathias**. Who ought to take the lead in that?

Mr. **Rohatyn**. Clearly the United States, Senator. The United States is the leading world power and the dollar is the standard currency, the standard reserve currency. Only the United States can take the lead.

But it would have to be done as part of a plan with the United Kingdom, with Germany, possibly with France, certainly with Japan. And it would have to aim at a certain coordination of policy.

Senator **Mathias**. Mr. Cline, in your very interesting paper you come to the conclusion of saying that you do not subscribe to the thesis of irresponsible lending. Is that right?

Mr. **Rohatyn**. Yes, sir.

Senator **Mathias**. What about irresponsible borrowers in the sense that borrowing nations may have adopted irresponsible economic policies?

Mr. **Rohatyn**. I think there are clearly instances of that, and I cited in fact the over-valued exchange rate of Chile and Argentina; the very much delayed adjustment measures in Mexico once it was realized that the oil market was softer than they had anticipated. Even so, the budget deficits kept rising because the country was going into an election.

So, there are certainly cases—and important cases—of improper domestic policies. But it seems to me as the central broad reason for the current problem one cannot attribute irresponsible policy either on the side of the lenders or the borrowers as a principal cause.

Instead, the principal cause has been the worst global recession since the Great Depression, extremely high interest rates, and international economic factors.

Senator **Mathias**. Senator Proxmire?

Senator **Proxmire**. Mr. Rohatyn, in testimony before the Senate Banking Committee on February 23, 1982—less than a year ago—regarding the Polish debt situation you said:

> I hold firmly to the view that Poland should be declared bankrupt and that the rescheduling of Poland's debts as well as those of other Eastern European countries, such as Romania, be suspended. That new credits to Eastern Europe should not be made available by the Western banking system at this time. That the financial and economic burden of the satellite states be placed squarely upon the Soviet Union.

> And that future credits to Eastern Europe become linked to the total range of issues presently under negotiation with the Soviet Union, possibly even with arms limitations.

Now, in today's statement there is a new feeling. In your prepared statement you say:

> We should, together with our European allies, propose a long-term refinancing plan for Eastern Europe in which the Soviet Union would join us and would provide half the credits and assume half the commitments.

What accounts for your change of opinion?

Mr. ROHATYN. Senator, I have not changed my view. I still believe that the bankruptcy of Poland ought to be the first step in a negotiation with the Soviet Union. I think that it is ultimately in our interest and in the interest of Western Europe to have normalized and growing trade relations with Eastern Europe.

But I think that should only happen as part of a package in which the Soviets contributes at least 50 percent. So, I do not believe it is inconsistent with the position I took in front of your committee a year ago. I still hold to the same position. I just view that as an extension of that position.

Senator PROXMIRE. When you appeared before our committee you did not say anything about 50 percent. You said, "that the financial and economic burden of the satellite states be placed squarely upon the Soviet Union," and so forth, "and future credits to Eastern Europe become linked to the total range of issues under negotiation, including even arms limitation."

Mr. ROHATYN. Yes.

Senator PROXMIRE. There is nothing in your statement here about linking this to arms limitation.

Mr. ROHATYN. Well, maybe it is because I shortened it. I absolutely do, Senator. I absolutely do. I think one of the problems—as a matter of fact, we keep talking about the world's economy and the recovery of the Third World, et cetera. And at the same time we are merrily going along burdening the world with $800 billion of arms sales every year, or arms investments. I think that is totally inconsistent.

I most certainly would link the two, Senator.

Senator MATHIAS. Amen.

Mr. ROHATYN. I would also say that when we begin to look at credits to less developed countries, we might question seriously whether those credits should be made available when at the same time they are being used for massive arms purchases that do nothing for the development of these countries.

I mean, there is more invloved here than accounting entries and I think that we have to look at it as such.

Senator PROXMIRE. Well, I think it is if not a different, certainly a more substantial expansion of your views that we got a year ago.

Mr. ROHATYN. I think that is quite possible, Senator. But I will settle for 50 percent from the Soviet Union, Senator, any time.

Senator PROXMIRE. Well, I think the Eastern European countries would be happy that there is that modification of views on the part of a very influential adviser to our Government.

Mr. ROHATYN. Senator, if I am an influential adviser to this Government that has escaped the notice of this Government. [Laughter.]

Senator PROXMIRE. It certainly has not escaped my notice. You win most of our battles one way or the other.

Mr. ROHATYN. Thank you, Senator.

Senator PROXMIRE. You come in through the back door, the side door, the window if you do not come in through the front door. [Laughter.]

But somehow, Felix Rohatyn's views are so often adopted.

Senator MATHIAS. I think he would like to think that he comes down the chimney. [Laughter.]

Senator PROXMIRE. Well, he is Santa Claus all right, ask New York about that. [Laughter.]

Mr. Cline, in your statement you say, "The IMF should be encouraged to borrow the required funds from private capital markets or from official lenders" under some circumstances, additional funds.

Now, why cannot the IMF if it can borrow these funds, borrow what they need from private capital markets instead of getting additional contributions from governments, including the United States? Could it do that?

Mr. CLINE. I think although it could try to do that, the basic principle is one of the risk-reward ratio for an investor. As an investor evaluates any potential investment he looks in some sense at the capital assets of that particular entity. And an increase in the quotas is a way of increasing the resources on hand for the Fund. That, in the first instance, should be done.

Senator PROXMIRE. I understand that, but it would make it easier for them to borrow if we contributed.

Mr. CLINE. Yes.

Senator PROXMIRE. And other countries contributed. But has there been any analysis as to whether or not they could borrow what they need absent our making this additional contribution?

Mr. CLINE. I am not aware of concrete analyses. I think the general sense is that the potential dimensions of the borrowing that is going to be involved in the next 2 or 3 years would be such that with the Fund coming into the markets for those kinds of amounts, without an increase in the quota, would raise questions about the kinds of rates that would have to be paid and the willingness of the capital markets to make those funds available.

Senator PROXMIRE. Mr. Cline and Mr. Rohatyn both, I think it is fair to say that the financial community generally supported the administration's economic policy. There may have been a few mavericks but by and large there was enthusiastic support for the Reagan policies.

Now we are in a recession. The administration forecasts only 1.4 percent growth this year. Yet is says the international community now agrees that world recovery is necessary to solve the debt problem, and everyone is calling for a U.S. growth policy right now.

Do you believe we can get a sustained, adequate recovery under present policies?

Mr. CLINE. I think we are moving in the right direction. I think the decline in the interest rate in the last 6 months is a crucial contribution. We need to continue to move in that direction. The Federal Reserve, in my opinion, should continue to follow a policy that brings interest rates down.

On the fiscal side, it seems to me, the key has to be sort of holding pat at the present because increased taxes at the present time could choke off recovery. But here I would agree with the earlier panelists that over the longer run we have to have a more credible fiscal package with lower deficits.

Senator **Proxmire**. Is that not a very difficult and chancy balancing act? Somehow we have to narrow the deficit over the next 2 or 3 years, otherwise we will be getting into $180, $200, maybe $300 billion deficits—enormous pressure on the capital markets, pushing interest rates up.

At the same time, we want to follow an expansive policy. It seems to me we are in a very difficult if not impossible situation for growth in our country and therefore in the world.

Mr. **Cline**. I think there is no doubt that that is precisely where we are. I do think that the nuance which is involved is that the calls for fiscal restraint have to obey a very careful timing because if we jump into fiscal restraint immediately—and this is 1983 and perhaps part of 1984 anyway—we do risk jeopardizing the recovery. There is really no economic theory which can demonstrate that if all else is held constant, and particularly monetary policy, that higher taxes will stimulate rather than restrain the economy.

So, there is a very fine balancing act and it involves this combination of monetary expansion with no change in fiscal policy in the very short term, but a more controlled budget in the outyears when we will be at higher employment, hopefully.

Senator **Mathias**. Could I intervene here because I would like Mr. Cline just to try to assess, if he would, the degree of importance in that rather somber picture he has just given us, the statement he made in his prepared testimony that:

> The reality, however, is that if there is no safeguard system in the system against international financial collapse, there could be far more unemployed on America's streets. Even the limited moratoria I have outlined within for Argentina, Mexico, and Brazil could imply a sharp increase in U.S. unemployment.

Mr. **Cline**. Yes; well, I think the way to integrate these is essentially the following: One looks at the domestic U.S. economy and the prospects for growth, given monetary and fiscal developments. And then one sees the international debt problem sort of coming down the side street. The two meet at the corner, and there is a good chance for a collision.

Basically, whatever risk we have of recession in this country is greatly heightened by the fragile international economic situation. And I think this is coming out in the administration's policy pronouncements now.

If one sees the administration talking about a move to expansion, it is not the cause of high unemployment figures at home that it cites. In fact, it is citing the risk of financial collapse internationally as the proximate cause for that modification.

Senator **Proxmire**. Mr. Rohatyn, may I ask you along that same line, do you agree that Congress should insist that the administration change the course of its economic policy as a condition for approval of the increase in the IMF quota? Saying that if it does not produce a convincing program for achieving growth, that action on the IMF quota at best be a stopgap measure and we might just have to increase it again in the future and it could not succeed without policies that will permit us to grow?

Mr. Rohatyn. Senator, there is no question in my mind that unless we have growth and unless we have significantly more growth than the 1.4 percent presently forecast in what I understand to be the current economic forecast in this country, that this process of rescheduling Third World debt and IMF assistance, no matter what it is conditioned on, is a bridge that goes no place.

And therefore, the two have to be viewed as two sides of the same coin. Whether you condition one on the other, that is a matter for your discretion.

Senator Proxmire. Can you suggest policies we might follow that would help us achieve a better than 1.4 percent growth, say a doubling of that growth, a growth of 3 percent, something of that kind?

Mr. Rohatyn. Well, Senator, I am not an economist. I think that we are in a situation that is very murky because most of the actions one can take create counterproductive results in many areas. I think the balance is exceedingly delicate.

It seems to me that the ultimate aim quickly has to be to reduce interest rates very rapidly and very forcefully.

At the same time, I do not believe that we should aim at brutally reducing the current deficit because I think that would make the recession deeper.

So, I think there will have to be a delicate balancing between having a credible budget policy that over the long run brings deficits down significantly—probably through a phased-in tax of the kind that John Heimann was talking about. I would support a big gasoline tax phased in over a period of time to do that.

Probably reductions in military spending growth and slowing down entitlement growth combined with, as I said, drastic interest rate reductions very quickly. And probably a program of Government-assisted investments, since investment has collapsed in this country.

Three-quarters of this country needs rebuilding physically, and I see no reason why we should not do that and put people to work doing it. Three-quarters of our older industrial establishment needs restructuring, and I see no reason why we should not go about doing that.

So I do believe there are a series of actions, probably of a much more interventionist type than anything anybody is talking about right now.

Senator Proxmire. All of the suggestions you just listed would require—unless I misunderstand them—substantial increases in Federal Government spending or lending.

Mr. Rohatyn. Not necessarily, Senator.

Senator Proxmire. And therefore contradict the position taken before this same committee earlier by former Secretaries of the Treasury Fowler and Blumenthal, and Charles Schultze who was here at the same time, who seemed to go in the other direction.

Mr. Rohatyn. I do not think it would require larger amounts of Government spending, Senator. It might require shifting spending patterns around.

Senator **Proxmire**. To reconstruct our economy, to build it up, you say that we have had enormous shortfalls—and I agree, we have that, certainly in steel, for example, and in many other areas.

Would that not require some kind of major Government lending?

Mr. **Rohatyn**. It might require major Government credit assistance. That might be paid off with this gasoline tax that I suggested phasing in over a period of time.

Senator **Proxmire**. How big a gasoline tax?

Mr. **Rohatyn**. Oh, I would go somewhat between 25 and 50 cents a gallon.

Senator, I did not tell you that this would be nice or pleasant.

Senator **Proxmire**. I want to say that Felix Rohatyn or many others, Members of Congress and so forth, we could take that easily, especially if you run to work.

But for people in my State who drive to work, make $10,000 to $15,000 a year and drive 30 to 40 miles in an old clinker, that is the way they get to work——

Mr. **Rohatyn**. But you can exempt people. You can give credits to people below a certain income level and make people pay who want to own 8-cylinder cars or BMW's, or whatever.

Senator **Proxmire**. You have argued that the Third World debt be stretched out at reduced rates. Suppose the banks do not agree? After all, most of this debt is private bank debt.

Would you favor holding up any IMF credits until such an agreement is in place as a way of using that leverage with the banks?

Mr. **Rohatyn**. No; I do not think that is practical, Senator. I think the reality of these debts is that they are long-term debts. What I am suggesting is that, again as part of a multilateral agreement with our other industrial partners, we consider setting up some kind of a multinational institution, or do this as part of an IMF or World Bank that would acquire these loans from the banks.

Senator **Proxmire**. How can a bank do this? Banks, after all, are in business to be able to pay dividends to stockholders and make profits, and so forth. How can they do that if they cut the interest they charge below the market rate?

Mr. **Rohatyn**. They would have a reduction in income. That might be better, however, than having a writedown on the principal amount of the loan if ultimately those loans are not repaid.

I am suggesting a structure which would provide the banks with a more secure, long-term credit at lower interest rates in exchange for what they have, which seems to me relatively high-risk loans at high interest rates.

I think as part of the package you could also relieve the banks—because you would be relieving the borrowers—of large amounts of interest burdens. Right now you would be relieving the banks of a equivalent amount of additional lending that they would have to make otherwise.

I think economically you can make a very rational package out of this. Whether you can negotiate the various pieces of it is another question.

Senator **Proxmire**. Your principal recommendation appears to be a long-term, low-interest rescheduling of loans to Communist countries, less developed countries.

Looking at it strictly from the Government standpoint, the IMF, the World Bank, and so forth, would not such low-interest loans constitute a subsidy? And if so, why should we subsidize foreign borrowers at the expense of the unemployed, the homebuilders, and the farmers in this country?

Mr. ROHATYN. It is no more of a subsidy than asking banks to reschedule loans that are in default. I mean, every one of these actions is a subsidy and you are doing it for two reasons, essentially.

One is to keep our banking system solvent.

Second, to keep the possibility of exporting to these countries in an interrelated system. If the Third World cannot function and cannot service its debts and cannot buy our products, we are going to have more unemployed.

Senator PROXMIRE. That is a very strong case and every witness that so far has appeared has strongly favored that. But we have not had any witnesses who represent the people out in America who need money, too.

They say exactly the same thing, only there we can see it more vividly. The people who are farmers, or who are home buyers, or car buyers—or sellers of these commodities—they say, "We are going to go down. We have been in dire trouble because we simply cannot get low-interest loans. We need those low-interest loans."

As interest starts going up again, which I think it is very likely to as we recover, we are going to get that pressure again.

How can I explain to a constituent in Wisconsin why we should make a subsidized low-interest loan to Mexico, or especially to Bulgaria, and then give them some kind of vague notion, "Well, there are going to be more jobs in Oshkosh."

Mr. ROHATYN. Well, you are giving subsidies in any case, Senator, when you provide money to the IMF. What you are doing is financing the rest of the world.

I think we ought to have low-interest loans in this country as well as rescheduling some of these loans on a low-interest rate in the rest of the world, and second, in terms of protecting jobs in American industry.

I am on the board of a company that manufactures automobiles in Kanosha, Wis. So I believe that you and I have similar constituencies. In this particular case I would argue that you can do a great deal by insisting on a change in the monetary currency system where you can keep these currencies within rational rates.

Senator PROXMIRE. You are not just proposing low interest for loans abroad but for domestic loans, too.

Mr. ROHATYN. I beg your pardon?

Senator PROXMIRE. You are proposing subsidized low-interest loans.

Mr. ROHATYN. No, I am not, Senator. You asked me if I had any views on changes in domestic policy that would create growth. I said, lower interest rates as a result of some other policies so that you will not discriminate, necessarily, among a rescheduling of Third World debt and what you can provide for somebody at home who wants to buy a car or a house.

Senator PROXMIRE. I have a number of other questions but the hour is late. You have been very patient. You have certainly been an excellent panel. We are deeply in your debt. Thank you very much.

The chairman, unfortunately, had to go to greet the Japanese Prime Minister, and he asked me to adjourn the committee until February 1.

Thank you very, very much for your excellent testimony.

[Whereupon, at 12:40 p.m., the subcommittee adjourned, to reconvene at 10 a.m., Tuesday, February 1, 1983.]

GLOBAL ECONOMIC OUTLOOK

TUESDAY, FEBRUARY 1, 1983

United States Senate,
Subcommittee on International Economic Policy,
of the Committee on Foreign Relations,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:05 a.m, in room SD-419, Dirksen Senate Office Building, Hon. Charles McC. Mathias, Jr. (chairman of the subcommittee) presiding.

Present: Senators Mathias and Pell.

Also present: Senator Proxmire.

Senator Mathias. The subcommittee will come to order. This is the fourth in a series of hearings on stresses and strains within the international financial system. This morning, we will be focusing on a range of recommendations for addressing the problems that confront the world economy.

As I certainly do not have to tell the distinguished witnesses who will appear here today, the problems are many; they are varied. The fact that they are interrelated makes them more difficult to deal with. We have national economies all around the globe laboring under high real-interest rates, growing levels of unemployment, under utilized industrial capacity, record budget deficits, persistent inflation, and I'm sure that all of you could add to that list.

The witnesses have come before the subcommittee in recent weeks, have stressed the absolute necessity for economic growth, particularly in the lesser developed countries. I regret that as I listened carefully—and I would rely on Senator Proxmire's memory, as he has been very faithful in attending—I do not believe any of the witnesses, however, was willing to offer very much optimism about the prospects for growth within the next year, within the near term. Most spoke of a modest recovery at best during the current year.

In this grim atmosphere, questions have been raised about the ability of private and governmental institutions to manage. We are seeing a rapid turnover in national governments as electorates react negatively to their economic prospects, and the solvency of private lending institutions has been brought into question by at least a few of the observers.

For a while, some people clung to the illusion that market forces alone would pull us out of our economic difficulties, and perhaps it was Mexico which gave us the signal that that was not to be. The real challenge is how to develop an effective, comprehensive and sustained response to the global economic difficulties that face us, and this is no small challenge. We must take very seriously the possibility that elements of the cure may be perceived by at least some to be worse than the disease.

If there is economic growth with lower interest rates in the industrial countries, this will create one set of circumstances. But if the growth is faltering, then the austerity measures being put in place in a number of debtor countries could prove to be politically unacceptable, which is a serious risk facing us at present.

We must be sensitive to the fact that what helps one nation may hurt another. Lower oil prices is good news for many countries, but certainly bad news for Nigeria, Indonesia and Mexico.

To help us wind our way through this economic mine field, we have a very distinguished group of witnesses. We are particularly pleased to have with us today Senator Bradley, who has given a great deal of thoughtful consideration to these subjects. He will be followed by a panel made up of the Honorable G. William Miller, president of G. William Miller and Company and former Secretary of the Treasury; the Honorable Robert Hormats, vice president for International Corporate Finance for Goldman Sachs; and Mr. William S. Ogden, vice chairman of the Chase Manhattan Bank.

Senator Proxmire, do you have any observations? Senator Bradley?

STATEMENT OF HON. BILL BRADLEY, A U.S. SENATOR FROM NEW JERSEY

Senator **Bradley**. Mr. Chairman, thank you very much. Let me say that I do not think that there are more important hearings being held on Capitol Hill than these, and I hope that the results of these hearings will be widely disseminated.

Since this is a hearing to deal with the specific recommendations, let me begin with my conclusions and recommendations first, and then provide the backup and then go to questions. I ask unanimous consent that my entire statement be placed in the record.

Senator **Mathias**. Without objection, it will be inserted in the record in full.

Senator **Bradley**. Mr. Chairman, the international financial system is in great stress. I recommend seven steps to relieve that stress and give us all some prospect that we will have economic growth again and a stable financial system.

First, we need to increase the IMF quotas to expand the volume of international credit or liquidity.

Second, we need to establish an emergency fund which could increase international liquidity quickly in a crisis. I might say both of these steps have been recommended recently by most of the finance ministers of the industrial world.

Third, we need to develop contingency plans for the central banks of the major countries to determine who would intervene as the lender of last resort to help banks in trouble.

Fourth, we need to convert the short-term debts of developing countries into longer-term obligations to prevent a solvency crisis.

Fifth, we need to improve the quality and availability of information about international banking to give policy makers and bankers a sounder basis for decisions.

Next, we need to coordinate the monetary and spending policies of the major industrial countries so that we can, indeed, achieve a global economic recovery.

And last, we need to modify the exchange rate system to prevent the wide swings in the exchange rate that are giving rise to protectionist pressure and misallocation resources.

Mr. Chairman, these recommendations are made against the backdrop of about the last decade, as the present financial crisis in international markets stems from the 1973–74 oil embargo. The increase in oil price was like a gigantic tax increase on the industrial economies and developing economies throughout the world. Although the price rise created hardship in the industrial world, our economies still were able to accommodate to the higher price. The industrial countries' banks were also the beneficiaries of the large volume of Petrodollars that OPEC had to invest.

In the Third World, however, there was no way they could accommodate that higher price and still maintain their economic growth and remain a market for our exports. So the choice after the OPEC cartel raised the price of oil was either to let the Third World enter into a depression with potentially vast starvation and with direct negative economic effects on the industrial world, or to find some way to allow them to continue to grow.

The Western economies could have increased the amount of aid to these Third World countries. Expanded aid would have allowed the less developed countries to pay the higher price of oil that was necessary to keep their economies growing, and to continue employing and feeding people. But in order to provide that increased aid, the industrial economies would have had to raise taxes or cut back on important government expenditures in defense, education or others, in order to generate sufficient revenues for aid distribution.

So, instead of governments providing the means by which Third World countries could pay the OPEC price increase and keep their economies alive, governments in the industrial world encouraged the private banking sector to fulfill that responsibility. Governments encouraged the private banking sector to lend the Petrodollars that OPEC countries had deposited with them to the Third World countries so they could pay the higher oil price.

The volume of these loans is enormous. The statistics are well known to the committee. Present public and private debt of Third World countries now rests at over $500 billion. The banks, in making these loans, did so without the normal prudence that one expects a banker to have before he makes a loan. There was very little, if any, assessment of whether the countries would be able to repay the debts, notwithstanding all the country desks in the foreign loan departments. But there was no way that each bank could duplicate the State Department, and if they did it, they couldn't begin to assess sovereign risks.

Bankers frequently remarked to each other and to others that countries never go bankrupt, and, therefore, their loans would be good.

To some degree, however, the banks were accepting the role of a sovereign state in making these loans to sovereign Third World countries with the encouragement of industrial countries' governments. The only difference was the banks did not have the power to tax if their loans turned sour.

The loans made during that early period were very profitable, in part because many carried a variable interest rate. During the inflationary period of the mid-1970's the banks found that they could charge a rather high interest rate, and that most of the loans could be repaid because of rapid world inflation and rapid growth of many Third World countries.

Because of this increased profitability and because of different national banking regulations, the interbank network internationally expanded from only 200 banks in 1972 to over 1,000 banks by the end of the decade. The most well-known segment of the interbank network, the Eurodollar market, was already in place, but it expanded greatly as did a whole host of off-shore banking centers.

The recylcing of Petrodollars to the developing countries and to multinational corporations, which greatly increased their borrowings in the unregulated Eurodollar market, made the interbank business quite profitable during the first 5 years after the oil price shock.

But all of this came to a standstill in 1979 as the world economy first began to enter the recession which still plagues us today and which threatens to persist long into the future. The recession began because of the very tight money in the United States, and it spread to other industrial countries. As industrial countries slowed down, they not only put people out of work, but they also provided less of a market for Third World countries to sell exports, which they desperately needed to do in order to get the foreign exchange to repay their loans to the private international banks.

Now, after a few episodes where Third World countries couldn't make repayments, banks faced a decision. Do they declare them in default or foreclose as they would under normal commercial transactions, or do they refinance? Almost without exception, the banks in Zaire, Argentina, Brazil, and Mexico all refinanced, because refinancing increased their assets and their returns on investments. Besides, how do you foreclose on a country? Maybe that's why countries don't go bankrupt.

Refinancing also reinforced the belief that countries, indeed, do not go bankrupt, and that ultimately they would grow and repay the loans. As a result of this refinancing, the debt of the Third World countries expanded even further. As more countries refinanced, debt piled upon debt.

When the Reagan administration came into office and enacted an internally inconsistent macroeconomic policy, very tight money and huge budget deficits, interest rates shot up higher than in the 1979-80 period, and guaranteed that the global economy would slide into a very deep recession.

What had all the makings in 1980 of a normal recession, some have argued, became a little "d" depression. That contraction is now the deepest since, indeed, the Great Depression. Unemployment in all countries has risen to postwar record highs, and industrial production and growth have plunged to record lows. As bad as it seems for us in the industrial countries, however, the impact has been worse on the developing countries.

The value of world trade has declined in the past 2 years, by 10 percent in 1982, and commodity prices have collapsed so that export earnings of developing countries have declined substantially. The continuing high, nominal and real interest rates have raised cost on loans with floating rates, and made it costly to take out additional loans.

Debt-service, as a percent of exports of goods and services, has risen to 129 for Mexico, 122 for Brazil, as high as 179 for Argentina. Such high debt-service ratios make it unlikely that many Third World countries will be able to repay their debt for sometime in the future, if at all. Already, by August 1982, Mexico essentially went broke and was not able to repay its loans. At one point early last fall, Mexico only had $100 million in international reserves; enough to cover only 2 days' transaction. Brazil soon followed, and Argentina has also been unable to meet its past obligations. These three countries combined have debt of over $135 billion to private banks.

As a result, the whole international financial system began to get shakier. The IMF has about $40 billion in reserves and they could dole out these reserves to tide over countries in difficulty, but that is small compared to the $350 billion exposure to private banks, and the over $500 billion total debt by developing countries. Many people have begun to question whether the system could survive a shock or a series of liquidity crises.

Although done on an ad hoc basis, the United States, other central bankers, and the IMF put together an emergency package in the Mexican case with portions coming from the exchange stabilization fund and the U.S. Department of the Treasury and the treasuries of other central banks, and from the IMF through the use of the reserves it has available.

Similar packages were extended, as were other bridge loans to Mexico and Argentina. All of these loan extensions were made with the assumption that, although they do not have the cash today, the countries will get the cash tomorrow. They will get the cash tomorrow, the argument goes, because of the austerity measures the IMF will impose upon them.

The IMF conditions include monetary restraint and budget cuts, which essentially impose a recession on the economies, and apart from the political dangers of these austerity measures, which are substantial, such conditions require the country to take steps to make it virtually impossible for the country to grow again in the short run.

How, then, one might ask, will these countries generate the foreign exchange earnings needed to repay their loans from international banks? The world economy is, indeed, suffering from a paradox of austerity. Most industries are practicing macroeconomic restraint, and the IMF is imposing strict conditions on developing countries. Where will the growth stimulus come from? Global recovery will not spontaneously occur. The world economy lacks the liquidity to allow adjustment and expansion to occur.

Mr. Chairman, that is the core of the testimony. I would ask that the remainder of it, as I said earlier, be placed in the record. And I would say that the measures that I have recommended—increasing the quotas and emergency fund available for liquidity crises, solving the lender-of-last-resort problem, addressing the solvency issue directly, and improving the availability of information—are only going to work if we also get economic growth, as you have said, which means a coordinated expansion.

You can't have expansion in the United States and tight money and contraction in Europe and Japan. As we have learned in the last year, you cannot have expansion in France and contraction in the United States and get any kind of economic growth.

And I would like, in conclusion, to make one final point: that it was Government that, in the mid-1970's did not make the hard choice to tax our citizens or to cut the budget, to send the aid back to the Third World so they could accommodate the higher oil price and continue to be a market for our exports. It was Government that made that decision. It was Government that encouraged the private banking sector to fulfill a sovereign responsibility.

And, therefore, Mr. Chairman, I would argue that, since it was also Government that caused the depth of this global recession, that it is Government that must assist the adjustment process for the private banking sector. It is not something that you can label as a banker's problem. It is not a banker's problem. It is all of our problem. And, unless we can work together to solve it, there is a very real prospect that dire economic times remain ahead.

[Senator Bradley's prepared statement follows:]

Prepared Statement of Hon. Bill Bradley

FUTURE EVOLUTION OF THE INTERNATIONAL FINANCIAL SYSTEM

I appreciate the opportunity to appear here today to address this Committee. As the Chairman has pointed out in his introductory remarks and in an excellent article in the Washington Post, the world economy is at a critical juncture.

The worldwide recession has become the dominant political issue in most countries and its effects are now spilling over to international political relations in ways which have not been seen since the 1930's. Increasing protectionism is the most visible sign but the strains are also being felt throughout the international financial system.

The specter of default hangs over the financial system because the developing countries incurred large debts in recent years which in normal times they even find it difficult to repay. The private banking system overextended itself in making loans to many developing countries. Now the global recession and increasing protectionism are making it extremely difficult for many of these countries to service their debts and major banks are faced with mounting nonperforming assets. Unless the world economy gets going again, the threat of a financial collapse looms large.

Unfortunately, most industrial countries are framing their solutions to the global recession in a national context that overlooks the international dimension to the problem. Most industrial countries are still adopting austerity measures to fight yesterday's battle—the battle against inflation. As a result, the world is faced with a "paradox of austerity" similar to the "paradox of the thrift" we all learned about in introductory economics. If everyone is adopting austerity measures, where will the growth stimulus come from?

The severity and duration of the Great Depression of the 1930's were increased precisely because countries failed to join in an effort to solve problems at a world level. In my opinion, the only way out of the current recession is if the major countries collectively agree to a coordinated macroeconomic expansion.

The major countries will also have to agree collectively upon the future evolution of the international financial system. Significant changes have occurred in that system since the breakdown of the Bretton Woods system 12 years ago. Apart from the shift to floating exchange rates and the financing and recycling problems created by the two oil shocks, other fundamental changes have been the increasing openness and integration of national economies and the increased pluralism in the world economy.

Increased interdependence and openness mean that all economies have become more dependent on and vulnerable to developments in the rest of the world. Increases in trade and financial flows have strengthened the linkages between the separate national economies. The growth of the interbank marked and the expansion of private bank lending have played a vital role in the recycling of surpluses and financing of deficits, but this development was not consciously planned or closely regulated.

International interdependence has become a major constraint on the formulation of national macroeconomic policy. As the openness of a nation's economy increases, policy actions of its government have a greater tendency to spill over into the rest of the world, thereby affecting the ability of other countries to achieve their economic objectives. Similarly, foreign government policy actions and nonpolicy disturbances originating abroad can increasingly influence the ultimate objectives of home nations' economic policy. As one example of the consequences of interdependence, the recent abrupt change in macroeconomic policies in the United States tight money and loose fiscal policy caused an overvaluation of the dollar which has drastically reduced the competitiveness of U.S. industry and increased unemployment.

As international integration proceeded apace, national financial regulations have failed to keep pace. Moreover, the international character of the financial system means that much of the information that is needed in order to make sound decisions is not at the disposal of national policymakers or bank loan officers.

The emergence of important new actors—the OPEC countries and the newly industrialized countries—as well as the diffusion of economic power among the industrialized countries have increased the pluralism in the world economy today. Increased pluralism means that no single actor or even a small group of actors can dominate international economic affairs and therefore international agreement is harder to obtain. This is unfortunate because the increased linkages among our economies have intensified and broadened economic conflicts and those conflicts frequently become political and diplomatic issues. Diplomatic struggles are usually long drawn out affairs.

Ideally conflicts should be resolved by reference to international rules or by discipline imposed by international organizations, but rules are lacking and the organizations which sprung up in the immediate post-war period have been overtaken by events. And yet, there has been little discussion of the need for reform of our international economic institutions.

Today I want to review the recent dramatic developments in the international financial system, assess the adequacy of existing arrangements and raise questions concerning its future evolution. In my discussion, it will be obvious how what were once arcane subjects studied only by bankers and professors have become objects of intense political interest. That is the major reason that I believe the time for reform of the international financial system has arrived. For if we do not take steps to remedy the system's deficiencies, we run the risk of a repeat of the tragedy of the 1930's.

I. The Roots and Nature of the Present Crisis in the International Financial System

The present financial crisis in international markets stems from 1973–74 after the dramatic oil price increase and the oil embargo. The increase in oil price was like a gigantic tax increase on industrial economies and developing economies throughout the world. Although the price rise created hardship in the industrial world, our economies still were able to accommodate to the higher price. The industrial countrys' banks were also the beneficiaries of the large volume of petrodollars that OPEC had to invest. In the Third World, however, there was no way that they could accommodate to that higher price, maintain their economic growth, and remain a market for our exports. So the choice after the OPEC cartel raised the price of oil was either to let the Third World enter into a depression with potentially vast starvation and with direct negative effects on the industrial world or to find some way to allow them to continue to grow.

The Western economies could have increased the amount of aid to these Third World Countries. Expanded aid would have allowed the less developed countries to pay the higher price of oil that was necessary to keep their economies growing and to continue employing and feeding people. But in order to provide that increased aid, the industrial economies would have had to raise taxes or cut back on important government expenditures—defense, education, etc.—in order to generate sufficient revenues for aid distribution.

So, instead of governments providing the means by which Third World countries could pay the OPEC price increase and keep their economies alive, governments in the industrial world encouraged the private banking sector to fulfill that responsibility. Governments encouraged the private banking to lend the Petrodollars that the OPEC countries deposited in the private banking system to the Third World countries so that they could pay the higher oil price and buy products from the industrial countries. By the end of the 1970's over 35 percent of our exports of manufactures went to developing countries.

The volume of loans was enormous. The private debts of the developing countries rose from $40 billion in 1973 to $225 billion by 1979 and further to $375 billion in 1982. The loans have also been concentrated heavily in a few countries. In 1982 Mexico's outstanding private debt was $65 billion, Brazil's debt was $55 billion, and Argentina's was $25 billion.

The banks in making these loans did so without the normal prudence that one expects a banker to have before he makes a loan. There was very little, if any, assessment whether the countries would be able to repay the debts. Notwithstanding all the country desks in foreign loan departments. There was no way each bank could duplicate the State Department and if they didn't, they couldn't begin to assess sovereign risk. Bankers frequently remarked to each other that, of course, countries never go bankrupt and, therefore, their loans would be good. To some degree, however, the banks were accepting the role of a sovereign state in making these loans to sovereign Third World countries. A striking difference, however, was that the banks didn't have the power to tax if their loans turned sour and they had to store up their capital structures.

The loans made during that early period were very profitable, in part, because many carried a variable interest rate. During the inflationary period of the mid-1970's the banks found that they could charge a rather high interest rate and that most of the loans could be repaid because rapid world inflation and rapid growth of many Third World countries allowed them to make repayments.

Because of this increased profitability and because of different national banking regulations, the interbank network internationally expanded from only 200 banks in 1972 to over 1,000 by the end of the decade. The most well-known segment of the interbank network, the Eurodollar market, was already in place but it expanded greatly as did a whole host of offshore banking centers.

The recycling of the Petrodollars to the developing countries and to multinational corporations which greatly increased their borrowings in the unregulated Eurodollar market made the interbank business quite profitable during the first 5 years after the oil price shock. But all of this came to a standstill in 1979 as the world economy first began to enter the recession which still plagues us today and which threatens to persist long into the future. The recession began because of the very tight money in the United States and it spread first to other industrial countries. As the industrial countries slowed down, they not only put people out of work but they also provided less of a market for Third World countries to sell exports, which they desperately needed to do in order to get the foreign exchange to repay their loans to the private international banks.

Now, after a few episodes where Third World countries couldn't make repayments, banks—early on—faced a decision: do they declare them in default or foreclose as they would under normal commercial transactions? Or do they refinance? Almost without exception, the banks all refinanced—in Zaire, Argentina, Brazil and Mexico—because refinancing increased their assets and their return on investments. Besides, how do you foreclose on a country? Maybe that's why countries don't go bankrupt. But refinancing reinforced the very belief that countries don't go bankrupt and that, ultimately, they would grow and repay the loans. As a result of this refinancing the debt of the Third World countries expanded further.

As more countries refinanced, debt piled upon debt. When the Reagan administration came into office and enacted an internally inconsistent macroeconomic policy—very tight money and huge budget deficits—interest rates shot up higher than in 1979–80 and guaranteed that the global economy would slide into a very, very deep recession. That contradiction is now the deepest since the Great Depression. Unemployment in all countries has risen to a post-war record and industrial production and growth has plunged to record lows. As bad as it seems for us in the industrial countries, the impact has been worse on the developing countries. The value of world trade has declined in the past 2 years (by 10 percent in 1982) and commodity prices have collapsed so that export earnings of developing countries have declined substantially. The continuing high nominal and real interest rates have raised costs on loans with floating rates and make it costly to take out additional loans.

Debt service as a percentage of exports of goods and services has risen to 129 for Mexico, 122 for Brazil, and is as high as 179 for Argentina. Such high debt service ratios make it unlikely that many Third World countries will be able to repay their debt for some time in the future, if at all. Already by August 1982, Mexico essentially went broke and was not able to repay its loans. At one point early last fall, Mexico only had $100 million in international reserves, enough to cover only 2 days' transactions. Brazil soon followed and Argentina has also been unable to meet its past obligations. These three countries combined have debt of over $135 billion to private banks.

As a result, the whole international financial system began to get shakier. The International Monetary Fund has about $40 billion in reserves that it could dole out to tide over countries in difficulty but that is small compared to $350 billion exposure to private banks and over $500 billion total debt by the developing countries. Many people have begun to question whether the system could survive a shock or a series of liquidity crises.

Although done on an ad hoc basis, the United States, other central bankers, and the International Monetary Fund put together an emergency package in the Mexican case—with portions coming from the Exchange Stabilization Fund in the U.S. Department of Treasury, from the treasuries of other central banks, and from the IMF through the use of the reserves it has available. Similar packages were extended as were other bridge loans to Brazil and Argentina. All of these loan extensions were made with the assumption that although they don't have the cash today, the countries will get the cash tomorrow.

They will get the cash tomorrow because of the austerity measures the IMF will impose upon them. IMF conditions include monetary restraint and budget cuts which essentially impose a recession on the economies. Apart from the political dangers of these austerity measures which are substantial, such conditions require the country to take steps to make it virtually impossible for the country to grow again in the short run. How then will these countries generate the foreign exchange earnings needed to repay their loans from international banks?

The world economy is suffering from a "paradox of austerity." Most industrial countries are practicing macroeconomic restraint and the IMF is imposing strict conditions on developing countries. Where will the growth stimulus come from? Global recovery will not spontaneously occur. The world economy lacks the liquidity to allow adjustment and expansion to occur.

At this time of great stress in the world's financial system, we need to take extraordinary measures to calm the raging sea of liquidity crisis. In particular, we need to increase quotas for the IMF and to form an emergency fund to begin to deal with the crisis even if the total amounts of both could not possibly offset the total exposure. If done in a skillful way, these increases in liquidity could indeed stem panic, but only so far because as countries refinanced or had bridge loans extended to them, they still will have to repay these debts at some time in the future and perhaps at higher interest rates.

The question can legitimately be raised today whether these countries will ever get the growth necessary to repay these loans, given the demands of the international banking system on their economies for austerity. In my opinion it is unlikely that they will be able to get the money to repay the loans. That means, of course, that the need for sustained economic growth in the United States and the other industrial countries is substantial because only if we begin to grow will they even have the remotest chance of being able to get the foreign exchange to repay those loans.

But the steps that need to be taken to get the world economy growing again cannot be taken by any single country. We need a coordinated macroeconomic expansion in the short run. In the case of the United States, the United Kingdom and probably Canada, this will have to be a monetary expansion in order to lower short term interest rates. In Japan and Germany this will require a relaxation of fiscal policy with some monetary accommodation. Italy and France have already been pursuing expansionary policies. Only together will we be able to pull out of the current recession.

At the same time we embark on an expansionary macroeconomic policy in the short run, we must take steps to cut future budgets. Reducing future budgets is necessary in order to restore confidence and stability in our economies, but we clearly can't cut current budgets by $200 billion and we clearly can't raise taxes $200 billion in the short run, nor should we. The question in the short run is how to get our economies going again. So I would argue that rather than trying to trim back social programs or raising taxes in the United States, let's get agreement among the major industrial countries to expand our economies now while simultaneously taking steps to reduce budget deficits when the recovery is complete.

Equally important is the need to regularize the debt of developing countries in order to avoid a solvency crisis. International banks and, indeed, the entire international financial system are faced with a dilemma—what might be called a "vulnerability dilemma." If defaults are to be avoided, the debts and interest payments of many developing countries must be rescheduled and new loans must be made. However, increased lending makes the commercial banks more vulnerable by increasing their exposure to developments in developing countries. Increased bank lending also puts the developing countries deeper in debt which raises the potential for problems in the future. On the other hand, cutting back on bank lending to reduce exposure increases the risk of default and heightens the threat to the international financial system.

Thus, expanded private bank loans as a solution to the liquidity problem raises questions of confidence; whereas, efforts by private banks to reduce exposure in order to maintain confidence exacerbate the liquidity problem. In the meantime, the bank's owners are getting restless.

Consider what would happen if a stockholder wanted to sue the auditors of a major international bank because the bank is carrying loans to Mexico in its balance sheet at full value when we all know that they currently are worth only 10-15 percent of full value or worth nothing. A lawsuit could bring about a very serious writedown of assets which would have to be written down against capital. Since most of these big banks have only 3 percent capital-asset ratios, all of the bank's capital could be quickly used up as loans are written down and then the institution, itself, is bankrupt. Clearly we cannot accept that.

The private international banking system is too important to world trade and to peace and stability in the world to be allowed to go bankrupt. The key thing is to find a mechanism to regularize the difference between the face value and the market value of these loans to Third World countries.

I would argue that this is precisely an area where government should be involved. Some private bankers argue that things are going to turn around and they do not need government to be involved. I do not see it that way. After all, it was not private bankers (acting on their own) that pushed us to the brink of disaster, it was government policy asking the banking system to perform essentially a sovereign function by recycling Petrodollars back to Third World countries. Governments asked the private banking sector to recycle the petrodollars because they did not want to tax their own citizens even further after the OPEC price increase in order to generate enough aid for Third World countries. With private bank recycling, these countries could continue to be markets for exports from the United States and other industrial countries. Now with austere monetary policy, the government has pushed the banking system to the breaking point and now the government must step in and rescue the banking system.

Well, I'm saying, let's be preemptive—let's move in now, let's admit what the problem is, let's write down these loans, and let's find a way in which government can participate in this.

Government can step in in a number of ways, but all parties must share in the adjustment process. It should not be a clear bailout, but rather a process in which the private banking system has to write down the assets—maybe the government gives it a long-term bond that it holds on its books at full value and gradually pays off over a very lengthy period—40 or 50 years. Debtor country participation will also be required because you cannot forgive the debtor country totally.

An alternative method for consolidating some of the developing country debt comes from an analogy with housing and mortgage markets. In the United States when a national recession hits, it causes a depression in the housing industry. In the world economy, the developing countries on the periphery are similar to the housing industry in that they bear much of the brunt of the adjustment to macroeconomic shocks. In order to regularize and to stabilize the mortgage market for housing, quasi governmental authorities have been created in the United States which buy up outstanding mortgage loans at a discount. Perhaps creation of a similar authority separately or through an expanded IMF or World Bank could enable the private banking system to consolidate its outstanding loans including non-performing loans and at the same time reduce the debt-servicing costs for the developing countries. Of course both parties would have to sacrifice. The loans could be bought up from the banks at a discount by the agency and the agency could take responsibility for ensuring that the country uses its borrowings to invest in productive assets which will earn a return in the future. One way or another, I believe that a substantial portion of their debt has to be written off the books so that they can start fresh again, and have some prospect of economic growth.

So this is the environment in which we now are living—an environment fraught with potential danger. Even if we are to muddle through the current crisis, the deficiencies of the current system have been exposed and crises will reoccur periodically unless those deficiencies are repaired. That is why we need to have a thorough restructuring of the international financial system.

II. THE NEED FOR REFORM OF INTERNATIONAL MONETARY AND BANKING INSTITUTIONS

A. INTERNATIONAL BANKING

Even if a coordinated macroeconomic expansion were to be agreed upon, the shortcomings of the international banking system would remain. They include:

Inadequate information;

Lack of coordination among the various institutions;

Ambiguity over the lender of last resort;

Regulatory disparities among the various national markets;

Inadequate provisions for creating liquidity especially in a crisis.

The present international banking framework invites circumvention of national regulations. The dramatic growth of offshore banking centers is the best example. To the outside observer the present framework is short on rules and regulations and at times has the stability of a chain letter. The Banco Ambrosiano demonstrated how the existing arrangements for supervising international banking are inadequate.

Although some progress could be made on a piecemeal basis to fill the gaps, I believe a more thorough review is needed on a multilateral basis. Only multilaterally can the discrepancies be eliminated. Also only with multilateral agreement can the ambiguity over the lender of last resort be eliminated. Better international supervision and improved safeguards are needed to dispel the uncertainty which hangs over the system and which threatens to break out in a crisis of confidence.

One of the first steps should be to improve the quality and availability of information on private bank lending internationally. In order to adequately assess the risks, market participants need to know the volume of lending loan terms and the potential for future repayment. As it now stands, what information is collected is collected in a fragmented way by various agencies, the IMF, BIS, GAB and the World Bank. More coordination and centralization is needed. More extensive information exchanges are also needed. A useful private effort in this regard has been the creation of a new clearinghouse, the Institute for International Finance, consisting of 35 banks from 9 countries which will have its headquarters in Washington.

The ambiguity of the lender of last resort could be eliminated if the informal 1974 agreement among the G10 countries were formalized and its provisions publicized. In the case of a bank subsidiary in an offshore banking center or a consortium bank, whose responsibility is it if the bank were to get into difficulty meeting its obligations?

The major central banks should explicitly agree to contingency plans in case of a banking crisis. Those contingency plans should include stiff penalties for the affected banks in order to avoid moral hazard problems.

It is always difficult to determine how much liquidity would be needed in a crisis but contingency and swap arrangements should be expanded and methods established for quicker response to crises. The current arrangements are ad hoc and require massive coordination among private bankers. For example, over 100 banks were involved in the emergency package for Mexico. An expansion and wider participation in the General Agreement to Borrow (GAB) would be the best framework.

B. INTERNATIONAL MONETARY SYSTEM

The current worldwide difficulties amply demonstrate that the shift to flexible exchange rates has not solved the problems posed by inconsistent macroeconomic policies. The austerity measures being pursued in almost all countries have created a "paradox of austerity" with no one providing the growth stimulus. As a result, global demand (liquidity) has contracted and the developing countries are bearing the brunt of the adjustment burden.

Furthermore, the wide swings in exchange rates in the medium term are resulting in prolonged departures from equilibrium rates. As a result, resources are misallocated and protectionist pressures increase. The 25 percent appreciation of the dollar on a trade weighted basis has caused a decline in real growth in the United States by 1.5 percent and an increase in unemployment of over 1 million workers.

The time has come to consider modifications of the exchange rate system to moderate the wide swings in exchange rates in the medium term. Flexible exchange rates have not turned out to be the panacea that economists claimed they would be and now several prominent economists have called for increased intervention to maintain rates in "target zones".

Any intervention, however, will require much closer coordination of macroeconomic policies. The recent U.S. experience with Reaganomics and the Mitterand experiment of unilateral expansionism demonstrate the folly of one country trying to conduct a macroeconomic policy at variance with the rest of the world. Both of these governments underestimated the strength of the international linkages and now both have had to retreat because of the exchange rate consequences of their respective policies. Unfortunately the world economy is left with a paralysis in international policymaking.

In order to break through this paralysis, the financial leaders of the major countries should meet to review the deficiencies in the international financial system and to consider modifications in the exchange rate regime. This should not just be a routine meeting lacking in substance as recent Economic Summits have been. Instead the meeting should represent a bold step at reform—a Bretton Woods II if you will. Otherwise the individual national attempts to solve these pressing global problems could lead us to a repeat of the tragedy of the 1930's.

CONCLUSION

The current economic environment, in many ways similar to the 1930's, threatens the international trade and financial systems from which all countries have gained and prospered. Unless the major countries agree to cooperate and to address their common economic problems collectively, history could repeat itself.

The increased interdependence and increased pluralism in the world economy mean that no single country can afford to go it alone in an international economic affairs nor can any single country lead us out of the current malaise. Containing present problems is not within the capability of any of the major actors, governments or international institutions. The major countries must pull together as never before to restore prosperity to the world economy.

On macroeconomic policy, this means the major countries must agree to a coordinated expansion in the short turn while taking steps to reduce future budget deficits. At the same time, countries must resist adopting the beggar-thy-neighbor policies which increased the severity and duration of the Great Depression.

Global economic recovery and efforts to restrain protectionism, however, will not be sufficient to solve all of our current economic problems.

Developing country debt will continue to be a problem for some time into the future. Furthermore, the financial system's deficiencies have been exposed and in order to prevent similar problems from recurring, those deficiencies must be remedied.

The time has come for the nations of the world to convene a high-level financial meeting, a Bretton Woods II, in order to address these issues concerning the adequacy of international financial institutions and the organization of the international monetary system. Specifically, the following actions need to be taken:

Increases in general liquidity by expanding IMF quotas.

Methods to increase "crisis" liquidity through the establishment of an emergency fund which would be able to respond quickly to crises.

Removal of the ambiguity over the lender of last resort including the development of contingency plans by the major central banks.

Consolidation and regularization of existing developing country debt to prevent solvency crises.

Improvements in the quality and availability of information on international banking, including closer cooperation and sharing among the IMF, GAB, BIS and World Bank.

Modification of the exchange rate system to prevent wide swings in the exchange rate over the medium term.

Methods for improving coordination of macroeconomic policies of the major industrial countries in order to obtain a sustained non-inflationary recovery.

The problems facing the international financial system are grave, but they are not beyond our collective capability—if we act together. Convening a Bretton Woods II would be the first step toward the development of an international consensus for resolving our common problems and toward agreement on the shape of the international financial system in the future. The sooner that process begins, the better.

Senator **Mathias**. Unfortunately, Senator Bradley, I agree with your assessment. We are still in a very serious position.

You have referred to converting short-term debts of developing countries into long-term obligations, which is an interesting proposal. As you know, about 65 percent of the LDC debt is private sector debt. I am wondering whether you are suggesting that governments assume the debt on a long-term basis, or whether the banks themselves convert from short to long term.

Senator **Bradley**. Mr. Chairman, I am suggesting that Government has to play a role here. I do not think that we have only a liquidity crisis out there. I do not think it is a matter of giving another 6 months to Mexico, Brazil or Poland, and in that 6 months suddenly they will generate enough foreign exchange to repay the debt.

I think that one could possibly analogize to Europe in the 1920's with the German reparations. The problem there was that the victorious allies imposed very severe payments on Germany but did not give Germany the reasonable prospect of running a current account surplus that would allow them to make those reparation payments.

And the present conditionality of IMF plus the bad economic circumstances out there in the world make it very unlikely that the Third World countries will run a surplus in current account to be able to repay the debts. And that is indeed what they have to do unless we are going to continue the fiction that sometime in the future they will be able to get the foreign exchange to repay it, and, therefore, we will refinance and refinance and refinance.

Now, the question that you have asked is a very important one: How do you get from the short-term exposure which could explode tomorrow, next week, 3 weeks from now, 6 months from now, how do we get from the short term to long term? And there have been a number of suggestions about how you could do that.

It most probably would have to be through an international governmental institution—IMF, World Bank, probably IMF, a new facility perhaps, that would, in a sense, exchange paper guaranteed by all the countries to the private banking sector in exchange for their loans, probably purchased at a discount. And then, each central bank would have to address the capital structure of banks that, indeed, might have a slightly less valuable portfolio.

But in that way, you would extend the repayment of the obligation by the Third World country. For example, as a rough rule of thumb, if you took $300 billion of current Third World debt and changed it from the short term to the long term, say, at 6 percent at 25 or 30 years, the developing countries would have $15 to $20 billion that they would not have to pay in the next couple of years, but could be stretched out over a longer period of time. And with that kind of approach, you also would have their export earnings going to the repayment of debt, not exceeding more than 25 to 30 percent. Then they would have some reasonable prospect of growing and making the ultimate repayment.

So in my view, you cannot simply have the private banking sector refinancing and refinancing and refinancing. That is a chain letter, and the recession has brought that chain letter to an end. You have to recognize that Government was responsible in part for this development, and that Government has to play a role in solving its very critical phase.

Senator MATHIAS. Your chain letter metaphor is a very apt one, but a rather dangerous one, because we all know that the chain letter breaks down when one party drops out. The pattern then is broken.

Senator BRADLEY. That is unless the authorities find out who was responsible for the chain letter.

Senator MATHIAS. Just a couple of other points. You talk about an emergency fund to increase liquidity. Are you thinking here of something housed in an existing institution, or would this require a new institution?

Senator BRADLEY. I think the recommendation made by the various finance ministers in Europe 2 weeks ago is a good possibility. It could be done under the IMF.

Senator MATHIAS. Finally, just as a sporting proposition, how would you rate the chance of getting the IMF quotas through the congressional process and through the appropriations?

Senator BRADLEY. The quota increase, the doubling of quotas?

Senator MATHIAS. Let's say they negotiate somewhere in the 50-percent range, and that generates a $10 billion appropriation which we will have to handle here, Senator Proxmire will have to handle here, some time a little later this year. Just as a sporting proposition, what are the odds?

Senator BRADLEY. Mr. Chairman, I am not altogether sure that it has to be in the budget.

Senator MATHIAS. It is off budget, I think.

Senator BRADLEY. So that it does not increase the deficit. It was like funding for the strategic petroleum reserve.

Senator MATHIAS. It is sill money.

Senator BRADLEY. It is still money, I agree, but the point is, if your arguing is it going to affect those deficit numbers that all of us are worried about, the answer is no because we perpetuate the fiction of off-budget financing. But as you point out, it does have the same effect on the economy.

So if we admit that up front, and do not worry about the off budget fiction, then what we can say is that we have to present the numbers to our colleagues, and that if they do not see that without some kind of way of shoring up the short-term liquidity problem, we will definitely have a solvency crisis that will affect every bank and savings and loan in this country, with the dramatic contraction of credit and even further decrease in available employment.

If our colleagues do not see that, Mr. Chairman, then I think that I would be surprised. The key is to make the case clearly to them what it means to their district.

Senator MATHIAS. With your eloquent assistance and your willingness to make statements as clear and as forceful as you have made here this morning, I think the odds are improved that we will be able to take some action.

Senator Proxmire?

Senator PROXMIRE. Senator Bradley, congratulations on an excellent presentation. It is most expressive. I have always wondered what professional basketball players did when they were sitting in a hotel room in between games. Now I find out. You have obviously studied the international banking situation.

Senator MATHIAS. True or false?

Senator BRADLEY. Only in Holiday Inns. Not in Marriott.

Senator PROXMIRE. That still gives you a lot of time. But I think you have done an excellent job. You are the only witness we have had, however, and we have had a number, and as Senator Mathias, the chairman, has indicated, I have been at, I think, all the hearings, and you are the one who has indicated the direst expectations.

You are unique in saying, and I think this was your quotation, "recession will persist long into the future internationally." And most of the witnesses have indicated that they thought that it would not, and that is the justification for our going ahead with the additional replenishment of the IMF that is being requested, because it is a temporary situation.

Now, would you just give us a word on why you think that this situation is as bad as you have indicated to us? You made the assertion, but you have not documented it.

Senator BRADLEY. The assertion of why the recession will continue?

Senator PROXMIRE. You say it will continue. You haven't told us exactly why.

Senator BRADLEY. I do not see any of the normal forces of economic recovery, capital investment, exports, government spending, or consumer spending being the engines to pull this recession back to some kind of growth, out of a recession into a growth path.

Capital investment, you have 35 percent of capacity underutilized today. So who is going to build new factories? If you take a look at the growth projected by Mr. Feldstein, 3 percent, how long is it going to take at 3-percent growth to get back up to anything close to 90-percent utilization of capacity? A long time.

Senator PROXMIRE. He assumes that for 1983 over 1982, but 1984, he has 4-percent growth.

Senator BRADLEY. Right, which is not very substantial. So my point is that capital investment is not going to pull us out, unlikely. Exports are not going to pull us out, because the dollar is overvalued anywhere from 25 to 35 percent against major currencies in the world, making our products much more expensive abroad, much less attractive.

Government spending. It is unlikely that government spending is going to act as a catalyst to pull us out of this recession, and the reason is that you can't spend enough. You have a $200 billion budget deficit as it is now.

And last, consumer spending. How is that going to pull us out? People who see the downturn in inflation, which is a good thing, say, well, we are going to withhold our expenditures, and particularly do they say this when roughly 1 in 3 families in the country is in some way affected by unemployment, and they are fearful for their jobs, and are therefore holding back on consumption.

Senator PROXMIRE. How about recovery in other developed countries? Is it a better or worse prospect?

Senator BRADLEY. In my view other countries are worse than we are. I think, notwithstanding what I just said about those detriments to economic recovery, I think that we have a more dynamic economy that is less subject to the winds of world trade; nonetheless, significantly affected.

A country like Germany is in very serious problems. The Germans have had 2 years of negative GNP growth. This year, they will have their third year of negative GNP growth. Their unemployment is 9 to 10 percent. Now, remember, this is 9 to 10 percent after they have sent home about 2 million guest workers. If you figure in the guest workers, their unemployment would be 16 to 17 percent.

For all of the OECD countries next year, the projection is 32 million unemployed.

Now, that is the kind of atmosphere that feeds on itself, and that does have political ramifications, so that is why you need, in addition to the steps to increase liquidity, in addition to the contingency plan for lender of last resort, and for meeting the solvency crisis, that is why you need a coordinated expansion. The United States cannot do it alone.

Let us say we change. Let us say that when Paul Volcker submits his money supply targets in the next couple of weeks, that he does not go with the 3- to 5-percent range that people had expected. Let us say that he admits that what he has been doing is expanding about 14 to 15 percent, and he is going to continue that.

Well, we cannot do it alone. You have to get the Germans to begin to reflate. You have to get the Japanese to practice a much looser fiscal policy with a coordinated approach that recognizes the battle now is not inflation, but the battle is operating a very serious downturn.

Then you have some reasonable prospect of getting out of this, but the reason that I am somewhat pessimistic that that is going to occur is that I frankly think the administration damaged its credibility terribly with the other economic leaders around the world in its first 2 years in office. I think that its adherence to the supply side myth that somehow or another you are going to cut taxes and have more revenue discredited it with most of the other industrial countries that knew that that was not going to happen, and they could not figure out why the administration was maintaining that, and they predicted that the result would be gigantic budget deficits.

So that is why I am not altogether sure that we are going to get a coordinated economic response and why I am not altogether saying that we are going to have a booming recovery by July.

Senator PROXMIRE. Just one other question. I understand the 10 largest banks have an average of 130 percent of their capital loaned to Mexico, Brazil, and Argentina. You have indicated that the outlook for Mexico is very grim indeed. And it looks as if even with the prescription you have given her, they may not be able to repay.

Do you think there is a prospect that a shareholder could file a lawsuit on the grounds that the banks are not now stating the real value of the obligations they have owing to them?

Senator BRADLEY. I am not a lawyer, Senator Proxmire, but my guess is that certainly someone could file a shareholder's suit alleging that. My concern, and I think your concern, and the chairman's concern should be what happens if indeed that occurs, and it is at that point that you have to be concerned about the capital structures of banks, and that is why you have to have some measure to shore up those capital structures if indeed that happens.

But more importantly, that is why you have to avert that from happening by stretching out the short-term obligations into longer-term obligations. If this is a morning when we are feeling our worst fears, my worst fear is if we do nothing now, and no shareholder files a suit against the bank, and indeed we get through a little period here, but we still do not solve the problem.

And 4 to 5 years out you have not Mexico or Brazil or the other third world countries individually coming in asking for some kind of help or stretch out or forgiveness or whatever, but you have indeed 10 or 15 bright young diplomats from around the world getting together who are all debtors and forming a debtor cartel.

It is at that point that indeed we have a very serious problem, and that is why we have to act pre-emptively to prevent that kind of power from resting in the hands of who knows what group of people 4 to 5 years, 6 years down the road.

So, I would argue that we have to face up to these problems. Brazil, Mexico, and Argentina, are in a sense dynamic enough economies that indeed, given the right circumstances, they would have a reasonable prospect for growth.

Poland, I don't know. That is kind of the answer to a riddle. When are we going to have a booming recovery? And the answer is, when you start to buy Polish exports, because if you are a German bank, and these are primarily German banks, and you look at the Polish loans, they are in default now.

The question is only how you handle it with your books. The question is, are they in default. The question is not, will they ever have some possibility of repaying those loans, because the answer is pretty clear, no. So, the only question is, how do you handle it with your books? And my point is that that problem for the German banks could, although it is unlikely, become a problem for more banks unless we act pre-emptively.

And again, one final comment. It is our responsibility to do so, because it is the governments of the industrial world that have precipitated this crisis in the private banking sector.

Senator PROXMIRE. Thank you, Mr. Chairman.

Senator MATHIAS. Thank you very much, Senator Bradley, for a very valuable and useful contribution to the hearings, if not very cheerful. Thank you.

Senator BRADLEY. Thank you very much.

Senator MATHIAS. We will now hear from our panel composed of Secretary Miller, Assistant Secretary Hormats, and Mr. Ogden.

Gentlemen, do you have any order of priority that you prefer?

Mr. MILLER. Mr. Chairman, if it would be all right, I would be happy to make a few brief remarks.

Senator MATHIAS. Let me say, we appreciate the statements that you have all filed, and they will all be included in full in the record. So, you can feel free to summarize them as you will.

STATEMENT OF HON. G. WILLIAM MILLER, PRESIDENT, G. WILLIAM MILLER & CO., WASHINGTON, D.C., FORMER SECRETARY OF THE TREASURY AND FORMER CHAIRMAN, FEDERAL RESERVE BOARD, WASHINGTON, D.C.

Mr. Miller. Mr. Chairman and Senator Proxmire, I know that your subcommittee has already had expert and informed testimony about the condition of the international financial system and world economic conditions. I will not endeavor to repeat any of that.

Senator Bradley has outlined very effectively not only problems, but also potential solutions. I would endorse almost all of his recommendations for action. So, rather than trying to catalogue a similar list, perhaps I could merely put the issues into a slightly different perspective, taking a look from another vantage point at some of the problems and possible solutions.

We live in a world that is far more interdependent than historically has been the case. As we address the issues before the subcommittee, it is clear that we are unlikely to resolve them unless we recognize that that interdependence requires a greater degree of coordination and cooperation in international matters than has been practiced in the past.

In terms of the world economy and the financial conditions that have caused stress and strain, we do have a series of dangers and dilemmas. As Senator Bradley pointed out, to the degree that many of the developing countries have incurred heavy debt loads, and to the extent that the IMF and other international institutions have endeavored to help solve this debt problem through adjustment processes, these are competing forces that work against the very world economic recovery we seek.

When developing countries have heavy debt loads, and the adjustment process requires that they reduce their own imports and coincidently seek exports, and when this occurs in many countries at the same time, the effect is to shrink the overall level of world trade. This tends to exacerbate the problems of economic stagnation and declining growth, and therefore makes it more and more difficult to accomplish the desired adjustment.

While I will not take time to repeat earlier comments, I would like to suggest a fundamental priority that is essential if we are to find solutions to current international financial difficulties. That priority is to find a way to bring about a vigorous world economic recovery that is sustainable and stable. In my opinion, accomplishing this depends upon a U.S. economic policy which seeks a dynamic, growing domestic economy, capable of providing useful and satisfying work for all employable Americans in an environment of reasonable price stability and the equitable distribution of opportunity.

As the American economy goes, so goes the world's economy. Unless we achieve renewed, sustained U.S. economic growth, I doubt that we will see early solutions to the strains and stresses of the world financial system. To get America growing again, we need to make a fundamental and major change in our economic policies. In particular, we need to make a major change in the fiscal-monetary policy mix. We need to undertake immediately and urgently a path toward much lower Federal deficits with a complementary monetary path which fosters noninflationary growth.

This would produce lower interest rates than will otherwise prevail. Such lower interest rates would not only contribute to vigorous domestic and world recovery, but also alleviate the international financial strains which are the subject of your hearing. If we do not expand the world economy, I suspect the problems will grow larger.

Senator Bradley also mentioned the importance of coordination. I certainly endorse and reemphasize this. He also mentioned at least some aspects of strengthening the international financial institutions. It is important that the Congress—the administration and the Congress—support and endorse and legislate as quickly as possible the proposed increase in the General Agreement to Borrow of the IMF, which is the fund that Senator Bradley spoke of. In addition, there will need to be support and prompt legislation for a substantial increase in the IMF quota.

Beyond this, I believe Congress and the administration should consider accelerating the contributions of the United States to the International Development Agency of the World Bank. Under our international agreements, the United States undertook certain annual contributions to this Agency—IDA—which helps the poorest of the poor nations. We have fallen behind in meeting our international obligations. It would be in our self-interest not only to meet that obligation on time, but to accelerate U.S. payments in order to speed up the process of helping the poorest of the poor countries and thereby contributing to much needed growth and political stability.

Let me remind the committee, as I am sure you know, that this is not just a question of helping other countries. It is a question of helping the United States. One out of five U.S. manufacturing jobs is for exports. One out of three acres of U.S. agricultural land raises food for export. The United States is now facing amazingly large deficits in our international merchandise trade. Unless we increase the wherewithal for growth and progress in other countries, and particularly the developing world—which represents such a large share of international trade and absorbs such a large share of U.S. exports—we are not likely to create the number of jobs needed by Americans.

In my opinion, this Congress should discontinue the procedure of including authorizations and appropriations for the IMF and World Bank in the foreign aid bill. These items should instead be included in a separate bill that is titled, "International Investments." The United States is making investments in those institutions by purchasing shares or making capital contributions that represent not foreign aid but a sound recognition of our own self-interest and aid to Americans through the creation of jobs within our own borders.

We should make it clear to the American public that that is the purpose of our support for the multinational financial institutions.

It is also important that we try to cope with the excessive fluctuation in currency exchange rates. A great deal of the difficulties we now face in international trade are rooted in the wide fluctuations experienced in currency exchange rates. The 40 percent increase in value of the dollar in relation to the yen over the past couple of years, for example, has done more to create tensions, to foster protectionism, and to create divisions with our Japanese ally than perhaps any other trade-related issue. If we could correctly achieve greater stability in currency exchange rates, we would make a giant step toward improving our balance of trade with Japan, and with other countries, and thereby relieve a great deal of stress.

This should probably be undertaken by arrangements among governments and central banks to establish some committed zones of relationship between the dollar and the European currency unit of the European monetary system on the one hand, and between the dollar and the yen on the other hand. I think a three-zone system could work very well.

In addition to the IMF quota and GAB increases, there are other longer-term areas that I think deserve attention in strengthing the International Monetary Fund. One would be to continue the evolution any steps toward turning the SDR (Special Drawing Rights) of the IMF, into a true international currency of trade and account. Over time, the SDR should become an international currency unit which would be available not only as a reserve asset but also for use in world trade and finance. This would contribute to a more stable international financial system.

In addition, it would seem desirable to explore the possibility of the Governors of the IMF establishing a mandatory convertible currency deposit requirement for IMF member countries to provide liquidity for the IMF in time of stress without the delays and uncertainties of quoted increases. This could be set up on a standby basis, to be used in case of special need or emergency. Such deposits might be called upon only for a temporary period. This would certainly provide a reassuring financial safety net.

Mr. Chairman, those are some personal suggestions to supplement what has already been said. I would, of course, be happy to expand upon these or respond in other areas of interest to the committee.

[Mr. Miller's prepared statement follows:]

Prepared Statement of Hon. G. William Miller

Mr. Chairman and members of the Committee:

In previous sessions, this Committee has benefited from expert and informed statements and testimony on world economic and financial conditions. I shall not attempt to re-cover this ground.

My main concerns in these matters center on world recession, outlook for only slow recovery, international debt burdens, stagnation in world trade, high unemployment, general trends toward inward looking policies, and continuing undercurrent of inflationary pressures.

Under considerable strain and stress over the past fifteen or so years, the international economic and financial systems have demonstrated considerable adaptability and resilience. However, there is much room for improvement. The opportunity for stable world growth and prosperity, which would itself contribute toward world security, would be greatly enhanced by policies which strengthen the world economic community. Such policies would also be in the self interest of the United States.

Let me outline a few suggestions.

WORLD ECONOMIC GROWTH

The first priority should be to bring about a vigorous world economic recovery, with sustained and stable growth. This in turn depends upon a U.S. domestic economy, capable of providing useful and satisfying work for all employable Americans, in an environment of reasonable price stability and equitable distribution of opportunity.

American economic policies should be directed promptly and powerfully to stimulate real growth through a major change in the fiscal-monetary policy mix.

We need an immediate path toward much lower federal deficits, with a complementary policy that fosters non-inflationary growth. This would produce lower interest rates than will otherwise prevail, and contribute to vigorous domestic and world recovery, while at the same time alleviating international financial strains.

WORLD ECONOMIC COORDINATION

Another important priority should be to improve the coordination of fiscal and monetary policies among the industrialized nations.

STRENGTHEN INTERNATIONAL FINANCIAL INSTITUTIONS

Recent proposal for an increase in the International Monetary Fund's resource through increase in the General Agreement to Borrow and through a quota increase are encouraging. These should be given full support on the U.S. side.

The United States should also speed up its contributions to the World Bank's International Development Association.

Authorizations and appropriations for the International Financial Institutions should not be included in foreign aid legislation. Support for the IFI's represents a U.S. investment, which creates American jobs and helps our domestic economy. It is not foreign, but really domestic aid.

CURRENCY EXCHANGE RATES

The fluctuations in currency exchange rates in recent years have been far greater than can be justified by underlying fundamentals. The best way to avoid protectionists pressures and to reinvigorate world trade is to provide a system for more orderly adjustment in exchange rates. Governments and central banks should develop a program for maintaining an acceptable zone of alignment among the dollar, the European currency unit of the European monetary system and the Yen.

STRENGTHEN THE IMF

Over the longer term, we should work toward developing the SDR (Special Drawing Rights) of the International Monetary Fund into an International Currency Unit, to be available as a reserve asset and as a monetary unit for international trade and finance.

Governors of the IMF should also explore the concept of establishing a system of mandatory IMF deposits of convertible currencies by member governments. This would allow IMF resources to be available in relation to the growth of world trade and finance, and assure the IMF's ability to act promptly in providing for appropriate balance of payment adjustments in times of difficulty.

Senator **Mathias**. I am going to suggest that we withhold questions until we can address them to the panel at large. I do want to interrupt just for a minute because Senator Pell, the ranking minority member of the committee, has joined us and I think wants to make a brief statement.

Senator **Pell**. Thank you, Mr. Chairman.

I merely wanted to extend my personal warm welcome particularly to Mr. Miller, a constituent and a very old friend who has served our country well and distinguished himself. And I only regret that I cannot stay around for all the proceedings in this hearing.

You are always welcome on Capitol Hill.

Mr. **Miller**. Thank you.

Senator **Mathias**. Mr. Ogden.

[Mr. Ogden's biographical data follows:]

BIOGRAPHICAL DATA OF WILLIAM S. OGDEN

William S. Ogden is vice chairman of the Board of Directors and chief financial officer of The Chase Manhattan Corporation and The Chase Manhattan Bank, N.A. He has been the corporation's and bank's chief financial officer since 1976.

Mr. Ogden joined Chase National Bank in 1952. After various assignments in the European and Latin American areas of the bank, including management of the Caribbean Branches, in 1966 he was promoted to senior vice president and named executive for the Latin American Area.

In 1971 he was promoted to chief administrative officer of the International Department and promoted to the position of executive vice president. He headed the International Department from 1972 through 1975. In late 1975 he was designated a member of the Management Committee of the corporation with the responsibility for the International Deaprtment and the Corporate Treasury, along with the Controllership, Financial Planning and Budgeting, and Economics functions. He assumed the position of chief financial officer at that time along with the chairmanship of the corporation's Asset Liability Management Committee. In 1982 he was also named chairman of Chase Manhattan Capital Markets (Holdings) Inc., the corporation's principal investment banking subsidiary.

Mr. Odgen was born in New Jersey and holds a B.A. degree in political science from Rutgers University. He served in the U.S. Marine Corps from 1946 to 1948 and also attended the American Institute for Foreign Trade for Special Language Studies.

He is a director of the Private Export Funding Corporation. He is also a director of the Americas Society, Council and the Center for Inter-American Relations, and a trustee of the Committee for Economic Development and the National Planning Association. He is a member of the Council on Foreign Relations and serves on the Executive Board of the National Council on Foreign Language and International Studies and the British-North American Committee. Mr. Ogden has recently been named second vice president of the New York State Bankers Association.

Mr. Ogden is a member of The Pilgrims of the United States, the Stamford Yacht Club and The Sleepy Hollow Country Club. He and his wife, the former Marijona Dymsa, reside in Stamford, Connecticut. They have two children.

STATEMENT OF WILLIAM S. OGDEN, VICE CHAIRMAN AND CHIEF FINANCIAL OFFICER, CHASE MANHATTAN BANK, NEW YORK, N.Y.

Mr. OGDEN. Mr. Chairman, I welcome the opportunity to testify before this committee and have submitted a more comprehensive written statement to supplement my testimony this morning.

Senator MATHIAS. Mr. Ogden, I notice that some of the people in the room seem to have some difficulty in hearing. If you will pull the mike very close, I think that will help.

Mr. OGDEN. Thank you, Mr. Chairman.

Let me first review the essential nature of the international debt problem. I originally addressed this topic in a speech before the Manhattan Institute for Policy Research last October. Since that time, we have made a great deal of progress in understanding exactly what the problem is and even more importantly what it isn't.

My basic points in the October speech were the following:

First, our present debt difficulties constitute a temporary liquidity problem, not a permanent solvency problem. This situation arose from the unforeseen length and depth of the recession in the industrialized world and from the persistence of unprecedented high real interest rates.

Second, our major concern should be the possibility of a significantly worsened world economy and not, as some have argued, of the viability of the international banking system.

Third, the three major participants in this situation—the borrowing countries, central banks of the industrialized countries, and multilateral financial institutions, and the world's commercial banks—possess the collective capacity to resolve the problem.

In October, these points were somewhat novel. Today, I think they are more generally accepted. More important, the actions implied in that earlier analysis are now being carried out with each of the three major actors accepting their share of the responsibility.

The borrowing countries have begun to take strong and often painful measures to reduce their balance-of-payments deficits, largely in conjunction with International Monetary Fund Credit agreements. Central banks and the multilateral financial institutions have stepped up to provide reasonable flows of liquidity on a global basis.

However, there is a serious question as to how long the key institution here, the IMF, can continue to exercise its responsibilities without receiving additional funding. I will return to this point in a moment.

As to the third actor, the vast majority of the world's commercial banks also have accepted their responsibility to continue to fund countries experiencing liquidity problems. The success of this cooperative effort has depended largely on the leadership of the IMF.

Increasingly, the formal credit agreements between the Fund and its member countries have become the centerpiece of a wider bargaining process involving not only policy commitments by the borrower countries but also new credit commitments by commercial bank lenders. Indeed, the lion's share of new lending is coming from the banks, not the IMF.

In the case of Argentina, Brazil, and Mexico, for example, the banks this year will provide additional funds that are more than twice as much as the IMF's scheduled disbursements.

Moreover, the amount of debt being rolled over by the banks is more than six times as much as the IMF plans to disburse, which leads me to the need for additional IMF funding. It is my firm belief that without prompt action to increase the Fund's resources, the IMF will be forced to impose restraints on new credits that are unreasonable, particularly when they are accompanied by tough austerity programs.

Therefore, prompt action by the Congress to augment IMF resources is the essential next step in further diffusing this debt problem. Such an IMF increase would in no way constitute, as some have suggested, a bailout of the banks. On the contrary, as William Dale, the IMF's deputy managing director, has put it, the provision of IMF credit to countries with liquidity problems "does not bail out the banks, it bails them in."

Specifically, IMF credit is not a means of facilitating disinvestment by the banks, nor of transferring bank risk to public entities, nor would a fund increase enable banks to escape the considerable risks chiefly in foreign private-sector loans where solvency problems exist and debt may have to be written down. Rather, such an increase would help reduce the risk that a nation's temporary inability to service its foreign debt will become a permanent disability and thereby worsen a recession that already is the most severe of the postwar era.

Will the banks benefit from an IMF quota increase? Of course they will. And so too will every other major participant in the world economy. As has been said before, "A rising tide raises all the ships."

While we should definitely increase the IMF's resources, we should not, in my judgment, overreact to this temporary liquidity problem by creating, as some have suggested, a tighter web of administrative controls around the foreign lending of banks. This would be unwise, unnecessary, and counterproductive to solving the world's debt problems.

Here, I would make three points: First, as President Reagan said last week in his state of the Union message, "This recession has been deeper than most inside and out of Government had predicted." None of us, neither governments in the industrialized world nor their central banks nor legislators nor regulators nor country borrowers nor commercial bankers accurately foresaw the severity of the recession that is the primary cause of our problems. Tighter controls over foreign lending would not have improved our ability to forecast, nor would they do so today.

Second, the resolution of the debt service problems of the borrowing countries requires negotiations on a case-by-case basis. Additional controls would introduce rigidities into a process that, by definition, demands flexibility.

Third, the extent to which international banks can continue to contribute to the solution of these problems depends directly on the severity of the penalty paid by the banks for their past decisions. Already, this penalty—in the form of reschedulings, nonperforming assets, and loss of flexibility—is a large one. To add to it through new and unnecessary punitive measures not only will diminish the ability of the banks to furnish needed new credits but also will increase the already-enormous pressures on official institutions to step into the breach.

Imposing tighter controls on foreign lending, then, is not needed. However, one thing the world's financial community does need is better information about the economic situation and evolving debt positions of borrower countries. To respond to this need—last month, 36 of the world's largest banks from nine countries created the Institute of International Finance, here in Washington. Membership will be open to all institutions with cross-border exposure. In the not-too-distant future we hope to have a membership of over 500 banks.

The Institute, of which I am interim chairman, was not established to address present problems but rather as a private-sector initiative to improve the process of sovereign risk lending and the long-term efficiency of international credit markets. It is not a lender's cartel. Rather, broadly speaking, it will perform four important functions for the benefit of all of its members:

One, it will gather country economic information, not to duplicate what is already being done, but to look for gaps in the information and seek ways to fill them.

Two, it will discuss with borrower countries, on a strictly voluntary basis, their economic plans, assumptions, and financing needs.

Three, when and where appropriate, it will serve as a focal point for dialog between the international banking community and multilateral institutions, central banks, and supervisory authorities in the developed countries.

Four, it will furnish members with country reports of an informational nature. These will be objective and will avoid making credit judgments, which will be left strictly to each member bank.

Such a process, skillfully and carefully executed, should tend to dampen excessive zeal and even excessive caution which, at certain times, can prove just as harmful in the country lending process. In other words, the Institute will trigger in each member neither red nor green lights but more probably yellow precautionary signals and better adherence to speed limits.

In closing, allow me to make two additional points. First, the resolution of the international debt problem presupposes a reasonably prompt and lasting recovery in the industrialized economies. A prerequisite to a sustained recovery is a further reduction of real interest rates. This is not simply a matter of lowering nominal rates. Long-run inflationary expectations must be reduced. And, while much has already been accomplished, further progress is hampered by concerns over the longrun course of the Federal deficit and its implications for future U.S. monetary policy.

Second, the question of how best to achieve a sustained recovery in the United States should be kept separate from the question I have focused on today—namely, What needs to be done to resolve country debt problems? To attempt to impose an "artificial linkage" between these two questions—to, in effect, hold action on the international debt question "hostage" to the achievement of concessions on domestic issues—would be a tragic mistake.

The margin for error in resolving the world's debt problem is relatively small, and the clock is ticking. As Paul Volcker said last week about this international situation, its solution is by no means yet "in the bag." A delay in augmenting the resources of the IMF would only encourage the economic and political dislocations in the borrowing countries that we all seek to avoid.

Conversely, by acting now to increase the Fund's resources, we will be strengthening a pivotal element in the ultimate solution of this problem. I am convinced that a bolstered IMF continuing to work hand in hand with central bankers, borrowing nations, and commerical bankers will allow us successfully to navigate our way through these problems. And that achievement, as Secretary Regan has said, is crucially important not only to the world's financial community but also most assuredly to the general economic interests of the United States.

Thank you, Mr. Chairman.

[Mr. Ogden's prepared statement follows:]

Prepared Statement of William S. Ogden

Mr. Chairman, distinguished members of the committee, it is a distinct privilege to appear before you today and share my perceptions as to the nature of the international debt problem and the actions needed to defuse the threat it poses to the stability of the global economy.

THE NATURE OF THE PROBLEM

If we are to design an efficient solution to a problem, we must understand its essential nature. In considering the nature of the international debt problem, I think it may be useful for me to begin by summarizing the three basic points of the address I made last October to the Manhattan Institute for Policy Research.

First, our present debt difficulties reflect a liquidity problem rather than a solvency problem—a liquidity problem arising from the unforeseen length and depth of the recession in the industrialized countries and from the persistence of unprecedentedly high real interest rates. Second, the key problem is not the viability of the international banks but the possibility of a significantly worsened performance of the world economy. Third, although the major actors had the collective capability of defusing the situation, that responsibility was not then being carried out. In particular, although resolution of the problem required the continued provision of substantial international credit flows from the private financial community, many sectors of that community were attempting to reduce foreign exposure.

Four months ago these points were somewhat novel. Today I believe they are generally accepted. I am particularly encouraged by the emerging consensus as to the first point of my October speech—that, in the main, our difficulties reflect a severe liquidity problem, not a problem of insolvency. As late as 1980, the ratio of foreign debt to exports in the developing countries was still relatively close to the level of 1973, the year preceding the first oil-price explosion. The buildup of developing country debt over the past 8 years has been accompanied by a similarly rapid buildup of productive capacity. This is not to say that in some cases these funds were not used to support poor monetary and fiscal policies. However, the heart of our present problem arises out of the difference between debt-service capability in the short run and long run—between the ability to export under current recessionary conditions and the capacity to produce for export. In short, there should be no presumption that the resolution of our present difficulties requires a massive write-down of existing debt.

I am also cheered by the growing understanding of the full range of potential consequences of a failure to address this global liquidity problem—that the consequences to the banks are less important than the consequences for the global economy, including the United States.

This last point is not simply rhetorical. The increased interdependence of the global economy is an inescapable fact. U.S. exports now total nearly one-tenth of our total gross national product, and more than one-third of those exports now go to developing countries that are critically dependent on continued access to international credit markets. The loss of a significant proportion of those markets would add markedly to our already unacceptably long unemployment lines.

What is most satisfying to me, however, is not the growing agreement with this perception of the essential nature of the debt problem, but rather that the program of action implied in that analysis is now being carried out. It is a straight-forward program based on the recognition that resolution of the problem requires that all of the major actors fulfill their individual responsibilities. No single group of actors—the borrowing countries, official financial institutions, or the banks—can solve our present difficulties by itself. Yet any group of actors, by failing to play its role, can trigger a series of political and economic upsets that would imply a significantly worsened performance of every major element of the world economy.

Before I move to the question of what future actions are needed, I thus think it important to review briefly what these individual responsibilities are and how they are being accepted.

WHAT HAS BEEN ACCOMPLISHED

For the borrowing countries the responsibility is to take strong measures to reduce their balance of payments deficits. Such steps are being taken, in large measure in conjunction with the negotiation of a credit agreement with the International Monetary Fund.

This complex question of how to reduce external deficits is and should be essentially a matter for the borrowing country to decide. The question of how much balance-of-payments improvement should be sought is a matter of joint determination between the borrowing country and its foreign creditors—public and private. This question has no precise answer. It depends on the borrowing history of the country concerned and its prospects for future debt-service capacity. All that is clear is that for the vast majority of the borrowing countries significant reductions in their international payments deficits are required and that achievement of this objective will necessarily entail somewhat lower economic growth—and in a few extreme cases a temporary lowering of the level of economic activity. The present debt problem has arisen in large part because the borrowing countries failed to foresee the constraints on their feasible growth path created by the prolonged recession in the industrialized countries. The borrowing countries must lower their short-term growth targets. Their freedom to respond to unexpected increases in their balance-of-payments deficits by borrowing rather than by domestic adjustment no longer exists.

For some countries this adjustment can be accomplished without the formal commitment entailed in an agreement with the International Monetary Fund. The discipline of such an agreement has become increasingly needed, however. The external funding gap facing most borrowing countries has increased, a result both of reduced export earnings and a reduced willingness of private institutions to supply foreign credits. These larger funding gaps entail an increased dependence on the IMF to provide greater assurance to commercial banks that domestic policy adjustment in the borrowing countries will be forthcoming.

These agreements between the Fund and its member countries with debt-service difficulties have come under a certain amount of attack. I would like to say that I am not among those who believe either that the Fund record with respect to credit conditionality is inappropriately rigid or inappropriately lax. I obviously do not wish to endorse every provision of every agreement that has been negotiated in recent years, but speaking generally, I believe these agreements have reflected both an understanding of what policy changes are essential and a sensitivity to the domestic difficulties of effecting those changes.

The second set of actors whose responsibilities I want to consider is public financial institutions—the central banks of the industrialized countries, acting individually or collectively through the Bank for International Settlements; and, most importantly, the International Monetary Fund. I want to be careful not to exaggerate those responsibilities. These institutions have no responsibility to guarantee any given rate of growth to the developing countries. They are not development institutions. Nor do they have the responsibility of protecting private financial institutions from the consequences of imprudent behavior. But they do have responsibility for the provision of reasonable flows of liquidity on a global basis and for the provision of lender-of-last resort facilities for their individual national banking systems. For the purposes of my testimony to you today I want to focus on the first of these responsibilities: the provision of reasonable levels of global liquidity.

The key institution involved in the exercise of this responsibility is the International Monetary Fund. With respect to the developing countries at least, the role played by central banks, although important, tends to be confined to the provision of liquidity on an extremely short-term basis—"bridging" loans in banking jargon.

There is ample evidence that the Fund is carrying out its responsibilities. It is providing significant flows of credit to member countries with liquidity problems. It has become the essential catalyst to the process whereby borrowing countries can be assured that the foreign credit assumptions underlying their adjustment efforts will be fulfilled—and the private international financial community can be assured that the borrowing countries will make those policy adjustments needed to achieve a significant reduction in foreign borrowing requirements. But there is a serious question, to which I will return, as to how long the Fund can continue to exercise its responsibilities if it does not receive additional multilateral funding.

For the international banks the responsibility is to maintain a long-run view of the creditor-debtor relationship. It is to provide an adequate funding package to country borrowers whose debt-service problems are a matter of inadequate liquidity rather than insolvency. It is to continue to supply new credits, albeit at a reduced rate, and to reschedule repayments of past credits.

Let there be no presumption that the present international debt problem can be resolved without the provision of significant new credits. The funding needs of those countries with debt-service difficulties must be reduced sharply. But they cannot be eliminated overnight. To attempt to do so would only set in motion a downward spiral of economic and political dislocations that would in fact threaten the long-term willingness of those countries to participate in the market economy and service existing debt.

The provision of relatively large, albeit reduced, flows of international credit from private sources is thus essential to the stabilization of the international debt problem. Assembling these needed credits is the responsibility of the banks. Exercising this responsibility is difficult, but it is proving feasible. The major international banks—the institutions with the firmest long-term commitment to international lending—must necessarily take the lead. But this commitment could not be maintained if those institutions with a more peripheral interest in international markets did not stay the course. Reestablishing the creditworthiness of those countries with severe liquidity problems requires the cooperation not only of the countries themselves but a complex array of financial institutions, many of whom have a limited understanding of the precise nature of their debtors' current difficulties and prospects.

The evidence of the complex negotiations of the past few months is that this responsibility is being accepted—not just by the major international banks but by the great majority of financial institutions that have foreign claims. In part the success of this cooperative effort by all segments of the international financial community is the direct result of the leadership provided by the IMF. Increasingly, the formal credit agreements between the Fund and its member countries have become the centerpiece of a wider bargaining process involving commitments by private creditors, typically both in terms of refinancing of past credits and the provision of new loans, that are in addition to the policy commitments by the borrower country and the credit commitments by the IMF contained in the narrower formal agreement.

Surprisingly, this major innovation has not received much attention in the public discussion of the international debt problem, but it is a fundamental change in the operating role of the IMF and a change that is essential to the ultimate stabilization of international credit markets. The implication of this innovation is that it closes what could have become a glaring gap—the possibility that injections of fresh public or multilateral credit would simply fund disinvestment by private creditors. The broadening of the agreement process has eliminated that possibility. To quote the Deputy Managing Director of the Fund, "The IMF is not bailing out the banks. It's bailing them in."

In fact, the lion's share of new international lending is coming from the banks—not official sources—even in circumstances where official credits are very large. In the case of Argentina, Brazil and Mexico, for example, the banks this year will provide additional funds that are more than twice as much as the IMF's scheduled disbursements. Moreover, the amount of debt being rolled over by the banks is more than six times as much as the IMF plans to disburse.

WHAT ADDITIONAL STEPS ARE NEEDED

That is what has been accomplished. Now let me turn to the question of what additional steps are needed. One critical item of unfinished business is the provision of additional resources to the International Monetary Fund. While there is no satisfactory answer to the question of what precise level of liquidity provision by the Fund is optimal, there is every reason to believe that without prompt action to increase IMF resources, funding constraints will soon force the IMF into restraints on new credits that are unreasonable.

Two proposals to augment Fund resources have been agreed to in principle at the executive level by the major industrialized countries. The first is a large—perhaps 50 percent—increase in IMF quotas to be accomplished by the end of this year. The second is a prompt and substantial enlargement of the resources provided the IMF under the General Arrangements to Borrow and the extension of the right to borrow under those Arrangements to countries that have hitherto been ineligible. Prompt action by the Congress on the Administration's proposals to augment IMF resources is the essential next step in defusing the international debt problem. Failure to take this further step would threaten to trigger the vicious circle of economic and political dislocations that we are all seeking to avoid.

The question is often raised as to whether such a step is an unwarranted "bailout" of the international banks. In considering this issue, I think it is important first to clarify the question being asked. The question of whether providing increased credit resources to the IMF is a "bailout" to the banks is often confused with the question of whether the banks would be better off if such support were forthcoming. The questions are not the same. Of course the banks would be better off if the fund were permitted to maintain reasonable levels of global liquidity. So would every major segment of the global economy, including ours. As has been said before, "A rising tide raises all the ships."

Posed meaningfully, the "bailout" question is not whether increased multilateral support of the IMF implies reduced credit risks for the banks as well as other institutions—which it does—but whether it implies a transfer to public entities of risks previously assumed by the banks—which it does not. The provision of IMF credit to countries facing severe liquidity problems does not bail the banks out. It ties them in. It is not a means of facilitating disinvestment by the banks—of transferring risk. It is not a means of escaping the very considerable risks in loans where solvency problems exist and debt must be written down. It is rather a means of reducing the risk that a temporary inability to service foreign debt will become a permanent disability—and that this most severe recession of the postwar era will become something worse.

What other actions should be taken? One school of thought holds that a stronger medicine is needed, and the stronger medicine prescribed is some form of asset-exchange system. A variety of schemes of this sort have been proposed, differing as to the nature of the new asset to be exchanged for existing bank loans, the originator of the new asset, the terms of exchange, and the comprehensiveness of the program, but they all have certain common features.

First, they provide for the exchange of claims against borrowing countries currently held by banks for claims against some governmental or intergovernmental entity—for example, the IMF, the World Bank, or a newly-established institution.

Second, they provide for a permanent reduction in the cost of debt service to the borrowing countries and a concomitant reduction of debt-service flows to the banks. This is to be accomplished either through a scaling-down of the debt totals or a reduction of interest rates to below-market, negative real levels or both. The extent of the proposed reduction of debt-service obligations of the borrowing countries and the translation of this reduction in terms of reduced debt-service payments received by the banks varies from proposal to proposal, but most envisage no subsidy element. That is, payments not made by the debtor country would not be received by the banks.

These proposals are extremely premature—if indeed valid at all. It is true that a prolongation or, even worse, a deepening of the current recession well beyond present expectations could transform today's liquidity problems into solvency problems for some countries.

Should this occur, it would be extremely important that the judgment as to the extent of debt writeoff be established through direct negotiations between creditor and debtor, rather than imposed from outside. The availability of foreign credit to countries forced into such a situation will necessarily be impaired for a considerable period of time, but the extent of this impairment will depend in an important way on the manner in which the new debt contracts were achieved. An imposed solution would create a permanent climate of uncertainty and mistrust in international credit markets that would be markedly more debilitating than a negotiated solution.

But I view this scenario as highly improbable. And, let us remember, not only do asset-exchange approaches imply unnecessarily severe long-term impairments of the efficiency of international credit markets; but they also tend to accept as a certainty what is only a possibility—and in my view an unlikely event. It is to accept the conclusion that the industrialized economies will continue to stagnate—that the international debt problem of most borrowing countries is doomed to become a solvency problem rather than a severe liquidity problem. Such prophecies are self-fulfilling and I cannot accept them.

A second school of thought proposes stronger medicine in the form of a much tighter web of administrative controls over foreign lending by banks—for example, the setting by regulatory authorities of country lending limits and the imposition of additional requirements with respect to loan-loss reserves. Such steps are not just unnecessary—they would significantly increase the difficulty of resolving the debt problem.

In support of this conclusion I would like to make three points. First, the assumption that tighter administrative controls over foreign lending by banks would have prevented the present debt problem is without foundation. It is quite true that the banks failed to forecast the prolonged severe recession that has been the primary cause of that problem. But so did the regulatory authorities. So did the economic decision-makers of virtually every country on the world. Our problems arose from a systemic failure that could not have been prevented through increased regulation. Indeed, increased regulation would simply have compounded our difficulties.

Second, the resolution of the debt-service difficulties of the various borrowing countries requires negotiations on a case-by-case basis. Additional administrative controls would introduce rigidities into a process that requires flexibility.

Third, the extent to which the international banking system can contribute to the future resolution of the debt problem is directly related to the extent of the penalty now being paid by the banks for their past decisions. This penalty—in the form of reschedulings, nonperforming assets, and loss of flexibility, is already large. To add to it through new administrative measures would diminish the capability of the banks to furnish needed credits, and add to the already onerous responsibilities of official institutions.

I do not mean to imply by these comments that no changes in bank foreign-lending practices are needed. Changes are needed. In particular, all segments of the private financial community need to become better informed as to the evolving debt position of the borrowing countries and the prospective economic performance of those economies.

To meet this need, last month 36 of the world's largest banks from nine countries created the Institute of International Finance here in Washington. In the not-too-distant future, we hope to have a membership of over 500 banks.

The Institute, of which I am interim Chairman, was not established to address present problems but rather as a private sector initiative to improve the process of sovereign risk lending and the long-term efficiency of international credit markets. It is not a lender's cartel. Rather, broadly speaking, it will perform four major functions: first, it will gather country credit information—not to duplicate what is already being done, but to look for gaps in the information and seek ways to fill them. Second, it will discuss with borrower countries, on a strictly voluntary basis, their economic plans, assumptions and financing needs. Third, when and where appropriate, it will serve as a focal point for dialogue between the international banking community, multilateral institutions, central banks and supervisory authorities in the developing countries. Fourth, it will furnish members with country reports of an informational nature. These will be objective and will avoid making credit judgments—which will be left strictly to each member bank.

Such a process—skillfully and carefully executed—should tend to dampen both excessive zeal and even excessive caution, which can prove just as harmful in the country lending process.

The final issues I would like to address today are the importance of economic recovery in the industrialized countries to the solution of the international debt problem—and the relationship between the measures needed to effect that recovery and the measures I have discussed that are more specifically identified as responses to the debt problem.

I think it is clear to all of us that a satisfactory resolution of our present international debt difficulties presupposes a reasonably prompt recovery of growth in the industrialized economies. The overall question of what further steps are needed thus transcends the question I have focussed on—what needs to be done to insure that the actors that are directly involved in the resolution of the debt problem can and will carry out their responsibilities.

This larger question—which asks what needs to be done to insure a prompt and lasting recovery of our economy and the economies of the other industrialized countries—is beyond the scope of my testimony today. Nonetheless, there are two comments I would like to make with respect to this larger issue. The first is that a further reduction of real interest rates is a prerequisite to the sustained recovery of the industrialized economies. This is not simply a matter of lowering nominal rates. Long-run inflationary expectations must be reduced. Much has been accomplished, but further progress is hampered by concerns over the long-run course of the federal deficit—and the implications of that deficit for the future conduct of U.S. monetary policy. Strong measures to reduce what now appears to be a large structural deficit in the federal budget, together with a stable monetary policy, are critical to our own recovery—and our own recovery is critical to the resolution of the international debt problem.

My second comment, and the point with which I will close, is that the question of how best to achieve a sustained recovery of the U.S. economy should be kept separate from the question I have focussed on today—namely, what needs to be done to resolve country debt problems. To attempt to impose an "artificial linkage" between these two questions—to, in effect, hold action on the international debt question "hostage" to the achievement of concessions on domestic issues—would be a tragic mistake. The margin for error in resolving the world's debt problem is relatively small. And the clock is ticking. As Paul Volcker said last week about this international situation, its solution is by no means "in the bag." A delay in augmenting the resources of the IMF would only encourage the economic and political dislocations in the borrowing countries that we all seek to avoid.

Conversely, by acting now to increase the Fund's resources, we will be strengthening a pivotal element in the ultimate solution of this problem. I am convinced that a bolstered IMF, continuing to work hand-in-hand with central bankers, borrowing nations and commercial bankers, will allow us successfully to navigate our way through these problems.

And that achievement, as Secretary Regan has said, is crucially important not only to the world's financial community but also, most assuredly, to the general economic interests of the United States.

Thank you.

Senator MATHIAS. Thank you, Mr. Ogden.

Mr. Hormats.

STATEMENT OF HON. ROBERT D. HORMATS, GOLDMAN SACHS INTERNATIONAL CORP., FORMER ASSISTANT SECRETARY OF STATE FOR BUSINESS AND ECONOMIC AFFAIRS, NEW YORK, N.Y.

Mr. **Hormats**. Thank you, Mr. Chairman.

It is a pleasure to be back here again and to discuss an item that we have discussed a number of times before in this forum; the international economy. Let me make a few general comments.

Senator **Mathias**. You appear today with a new hat and a new outlook and, I hope, a new solution.

Mr. **Hormats**. I will give it a try.

The importance of the world economy to the American economy, as this committee's earlier hearings pointed out, has grown in the past decade. Today, sustained domestic prosperity in the United States is virtually impossible without a well-functioning and prosperous world economy. For this reason, the subject before this committee today has a direct bearing on the American economy.

The international economy today is in a precarious state. In my judgment, at no time in the post-World War II period has there been a greater threat to its cohesion and to the fundamental principles of cooperation on which it is based. Even if an international financial crisis can be avoided, unless there are significant policy and structural improvements, we are likely to face a continued steady deterioration in the world economy which would add to the already serious economic problems of many countries, including the United States, and undermine political and social stability in many parts of the world.

The next few months in particular will be a very severe test for many countries, including our own, as to how we deal with this problem. The period between now and the Williamsburg Summit may be a particularly critical time, perhaps even a last chance, for leaders to demonstrate the wisdom and the political will to make necessary changes in both policy and the institutional arrangements.

It will be especially important during this period to overcome the tendency exhibited so often of late to react to events and pressures rather than pursue a forward-looking strategy. The attitude that was displayed by our leaders after World War II—that is, to develop an architecture of improved international monetary and trade cooperation—was based on their recognition that the interwar experience, with its barriers to commerce and capital, was both politically and economically harmful and that no country could insure its economic or its political well-being without a substantial measure of common effort to make the world economy work effectively.

A similar attitude, and eqully bold leadership, are no less important today in order to reverse the creeping deterioration and defensiveness which have come to be mutually reinforcing.

Responding to this committee's request for recommendations, I would like to take this opportunity to suggest a seven-point strategy to address the interrelated issues of growth, finance, and trade with a comprehensive series of measures to put economies on the path of sustained growth and to improve international cooperation toward that end.

It is not my intention to imply that this approach is in and of itself definitive or that its components are unique. Rather, it is to emphasize the importance of solving the major problems facing the world economy with a set of mutually supportive measures involving the major international institutions and a broad range of developed and developing countries.

No single meeting, such as a New Bretton Woods, is likely to bring about the progress needed, nor can any one country, including the United States, provide enough locomotive thrust to lead the way to international recovery. What is necessary is a soundly conceived set of steps in national capitals and in the IMF, GATT, World Bank, and OECD.

Moreover, problems years in the making will not be resolved overnight. Therefore, any strategy in order to be credible and effective must have both short- and long-term components, including certain measures which need to be taken right away and others to address structural and institutional difficulties which will take more time.

Let me for a moment turn to the problems that need to be addressed before I go through the general points of the strategy I would suggest.

First, I think that one key point that is very important to take into cognizance in this discussion is the interrelationship among the growth, financial, and trade issues. One might, to put it graphically, say we are caught in the midst of a triangle of economic instability. The three sides of the triangle are prolonged recession and high unemployment, debt-related constraints on growth, and serious pressures on the trading system.

These interrelated difficulties tend to feed on one another, and solutions to these problems have to take into account their interrelationships in order to be successful. One of the difficulties is that during the last three decades the economies of the world have become highly integrated. Developments in domestic economies have become intertwined with those of the international financial trading system. But for the most part, domestic and international economic policies and institutions have not adequately taken these interrelationships into account. International trade issues, financial matters, and questions of domestic economic growth and employment are generally addressed separately, with little understanding of, or attention, to the implications of actions in one area on the others.

A few examples of these interrelationships are, first, with respect to domestic policy, it is generally accepted, and indeed the logical answer, to high inflation that countries should tighten up on monetary and fiscal policy, or both, in order to reduce domestic demand.

But if many countries do this simultaneously, as in recent years, the result will be a mutually reinforcing and therefore in each country greater than anticipated decline in growth. And this is one of the problems we face today. That is why recession in most countries is deeper and longer than anticipated—because so many countries are attempting to apply anti-inflation remedies at the same time.

Second, with respect to the developing countries, many of these countries which in the 1970's were in fact the locomotives of world growth now face constraints on their growth, and import demand, as a result of weak demand for their exports, low commodity prices, high debts, and difficulties in securing new loans.

The problem here is that the traditional IMF remedy, and indeed the traditional economic remedy, for these difficulties is to tighten up on growth, reduce imports, and increase exports. The problem is that the world economy is in a situation where a number of countries are trying to do this all at once, and clearly every one cannot increase exports and reduce imports at the same time. And today, most developed countries and most developing countries are trying just that very strategy. The strategy is quite obviously a mutually frustrating one.

The last point relates to exchange rates. And the interrelationship there has changed rather dramatically. As has been pointed out in testimony today, the large deficit the United States faces is, in part, the result of an overvalued dollar. The difficulty is that in the past exchange rate movements responded largely to trade balances. Today the exchange rate movements are affected to a much greater degree by capital flows which respond to differential interest rates, differences in fiscal-monetary mixes, and political and security considerations. And this frequently means that exchange rates move in the direction opposite from that which is necessary to reduce trade imbalances. And this is another problem of interdependence which is particularly serious and has to be dealt with.

Let me turn very briefly to the seven points that I would suggest to address the objectives of resumed growth and improved cooperation.

First, I agree very much with the notion that we need a concerted effort by industrialized democracies to stimulate growth in ways which do not reverse recent declines in inflation and interest rates. Stimulative measures by nations in a position to apply them, even if individually modest, can taken together strengthen and broaden international economic recovery.

And here it seems to me that the major contribution the United States can make is to reduce the future year budget deficits. A budget deficit in a period of low growth is not inappropriate. Indeed, it is to be welcomed. The problem is that when there is an expectation that there will be large budget deficits in periods of high growth, it leads to the conclusion that the Government is going to be competing in the private market for both capital and goods. And that is going to mean a high level of inflation. It is the anticipation of that problem which has led interest rates, long-term interest rates, to be higher than they otherwise would be.

If the United States were to reduce substantially these out-year budget deficits, it would have the effect of reducing long-term interest rates and, in turn, allowing other countries to relax their monetary policies without a major risk that there would be an outflow of capital and a weakening of their currencies.

That is one way the United States can contribute to this overall stimulus. Other countries can do other things different, as I have pointed out in my written testimony.

The second element of any strategy must be a very ambitious program to deal with structural unemployment—both youth unemployment and problems of unemployment of workers who have worked in traditional industries and now find themselves displaced by capacity reductions or by technological shifts. This needs to be a priority in the OECD and at the economic Summit at Williamsburg.

The third element of the strategy, should be to deal with the financial problems of the developing countries. This involves sound policy measures by these countries themselves, IMF programs flexible enough to be both economically effective and politically and socially sustainable.

The point here is that frequently countries are asked to undertake stabilization programs which are so severe and cause such an abrupt reduction in growth that they undermine the stability of the very government being asked to undertake the program. It seems to me a program, to be credible economically, must also be sustainable socially and politically. I can get to this in a moment.

Another element in the financial program is a major increase in IMF quotas. I understand that there is some opposition in certain parts of this Congress to IMF quota increases. Let me just say that I believe a failure of this Government, both the administration and the legislative branch, to come up with a substantial IMF quota increase would reverse and undermine the economic leadership which the United States has shown since World War II.

It would, I think, be a major reversal of U.S. leadership in the world economy and reduce our influence considerably in many other aspects of the world economy. The last element of the financial aspect of this strategy is to sustain private financial flows in order to facilitate smooth adjustment. Mr. Ogden has spoken very well to that point.

The fourth element in the strategy would be closer and more systematic consultation among financial and monetary authorities, including from time to time trade officials, who in my judgment are wrongfully not involved in these issues because in many respects the financial monetary problems have a major impact on trade. If they were involved, it would be helpful. I think the need is for greater consultations to avoid exchange rate misalignments and volatility, especially where they distort trade flows and investment.

The fifth point is a commitment by all nations to resist new trade barriers and subsidies coupled with a renewed effort, supported by the Summit, to develop a consensus in favor of, and work programs to expeditiously achieve, major improvements in the rules and the dispute settlement procedures of the GATT.

The objective would be to aim toward a well-planned GATT ministerial meeting in 1984. This is particularly important both to the trading system and to the financial system. I cannot think of a worse blow to the international financial system than a retreat of a lot of countries into protectionism, and that is a major risk today.

There is a tendency of countries today to escalate protection and to react to, or to emulate, one another. There must be a determined effort by all countries to resist the tendency to build an economic Maginot Line around themselves, and an equally strong resistance to the desires of other countries to do the same. We must be vigilant with respect to our own tendencies in this direction and equally vigilant in pressing other countries not to think that they can erect Maginot Lines around their country.

The sixth point is that we need a Summit political commitment to strengthen public understanding of the need to increase developmental assistance, particularly to the poorer nations, and an effort to find ways to help countries suffering from the volatility of earnings from commodity exports. Here it seems to me, as Bill Miller has stressed, the IDA replenishment is particularly important.

I have just come back from a trip to Africa and Asia, and believe me, if we feel we are having problems, many of these countries, particularly in the poorer countries in the developing world, are facing disastrous situations. The IDA replenishment is seen by them as at least one ray of hope to help them deal with their problems, and it is a long-term investment in the world economy, as well.

The seventh point, is that we need, as we have had in the past, some exercise to help develop a consensus on how to deal with the structural problems of the world economy. As you may recall, Mr. Chairman, before the Tokyo round of trade negotiations, there was a group set up—under the chairmanship of Jean Rey—of senior international economic statesmen.

It seems to me we need today a distinguished high level group to address the institutional problems facing the world economy and to recommend ways to overcome them, with special emphasis on possible institutional changes to deal with the interrelationships among growth, trade and monetary issues.

These are the general recommendations I have, Mr. Chairman, in response to the committee's request, I, as other members of the panel, I am sure, would be delighted to answer questions.

Thank you.

[Mr. Hormats' prepared statement follows:]

PREPARED STATEMENT OF HON. ROBERT D. HORMATS

I appreciate the opportunity to testify at this series of hearings on the international financial system. In my current position at Goldman Sachs, and in past positions in the U.S. Government, I have closely followed developments in the international economy and participated in a variety of meetings and decisions concerning it. The importance of the world economy to the American economy has steadily grown in the past decade. Today, sustained domestic prosperity in the United States is virtually impossible without a well functioning and prosperous world economy. For this reason, the subject before this Committee has a direct bearing on the American economy.

The international economy today is in a precarious state. At no time in the post-World War II period has there been a greater threat to its cohesion and to the fundamental principles of cooperation on which it is based. Thirty-two million people unemployed in the industrialized democracies and tragic setbacks to the prospects of most developing nations attest to the depth of the crisis. Even if an international financial crisis can be avoided, unless there are significant policy and structural improvements, we are likely to face a continued steady deterioration in the world economy which would add to the already serious economic problems of many countries, including the United States, and undermine political and social stability in many parts of the world.

The next few months will severely test the ability and commitment of many nations, including our own, to substantially and concretely improve their own economies and the world economy. The period between now and the Williamsburg Summit will be a particularly critical time, indeed perhaps a last chance, for leaders to demonstrate the wisdom and political will to make necessary changes in policy and institutional arrangements.

It will be especially important, during this period, to overcome the tendency exhibited so often of late to react defensively to events and pressures rather than pursue a forward-looking strategy. If, after World War II the Marshalls, Spaaks, Bevans and Monets had been content simply to address each problem as it came along, that period would almost certainly have been one of great turbulence and the major international institutions so essential in promoting recovery and prosperity would not have been created. But in spite of the enormous difficulties their countries faced, or perhaps because of them, these statesmen forged a forward, and outward, looking approach. Their commitment to the creation of the architecture of improved international monetary and trade cooperation was based on a recognition that the interwar experience, with its barriers to commerce and capital, was both politically and economically harmful, and that no country could ensure its economic or political wellbeing without a substantial measure of common effort to make the world economy work effectively.

A similar attitude, and equally bold leadership, are no less important today in order to reverse the creeping deterioration and defensiveness which have come to be mutually reinforcing. Responding to this Committee's request for recommendations, I would like to take this opportunity to suggest a seven-point strategy to address the interrelated issues of growth, finance and trade with a comprehensive series of measures to put economies on a path of sustained growth and to improve international cooperation toward that end. It is not my intention to imply that this approach is in and of itself definitive, or that its components are unique; rather it is to emphasize the importance of solving the major problems facing the world economy with a set of mutually supportive measures involving the major international institutions and a broad range of developed and developing nations. No single meeting, such as a new Bretton Woods, is likely to bring about the progress needed. Nor can the United States, or any other individual nation, alone provide enough "locomotive thrust" to lead the way to international recovery. What is necessary is a set of soundly conceived steps in national capitals, and in the IMF, GATT, World Bank and OECD. Moreover, problems years in the making will not be resolved overnight. Therefore, any strategy, in order to be credible and effective, must have short- and long-term components—including certain measures which need to be taken right away and others, to address structural and institutional difficulties, which will take more time.

The seven major points which I believe necessary for a successful strategy for resumed growth and improved cooperation are:

A concerted effort by the industrialized democracies to stimulate growth in ways which do not reverse recent declines in inflation and interest rates. Stimulative measures by nations in a position to apply them, even if individually modest, can taken together strengthen and broaden international economic recovery.

A similarly concerted effort by industrialized nations to identify from their collective experience, and expeditiously implement, progams which have demonstrated success in reducing unemployment, particularly structural and youth unemployment. This should involve a series of cabinet and subcabinet level meetings, including labor and finance ministers, in the OECD.

A four-part program to help developing countries overcome debt problems without an abrupt decline in their economic growth. This would include: sound policy measures on the part of these countries themselves, IMF programs flexible enough to be both economically effective and politically and socially sustainable, a major increase in IMF quotas to permit it to provide necessary support and sustained private financial flows to facilitate smooth adjustment.

Closer and more systematic consultation among financial and monetary authorities, including from time to time trade officials, to avoid exchange rate misalignments and volatility, especially where they distort trade flows and investment.

Commitment by all nations to resist new trade barriers and subsidies, coupled with a renewed effort—supported by the Summit—to develop a consensus in favor of, and work programs to expeditiously achieve, major improvements in the rules and dispute settlement procedures of the GATT. If this effort makes genuine progress, it should lead to a well-planned GATT Ministerial meeting in 1984.

A Summit political commitment to strengthen public understanding of the need to increase development assistance, particularly to the poorer nations; and an effort to find ways to help countries suffering from the volatility of earning from commodity exports.

Creation of a high-level international group to address the institutional problems facing the world economy and recommend ways to overcome them, with special emphasis on possible institutional changes to deal with the relationships among growth, trade and monetary issues and to broaden mutually beneficial ties between industrialized and developing nations.

I shall expand upon these shortly after a brief discussion of the problems we currently face.

RELATIONSHIPS AMONG CURRENT PROBLEMS

Having been asked by this committee to provide recommendations for the future, I will not dwell on the nature and origins of current problems. However, I believe that a short description of some of the relationships among these problems would be useful.

We are today faced with a convergence of three negative forces. Or, to put it another way, we are caught in the midst of a triangle of economic instability. The three sides of the triangle, are: (1) prolonged recession and high unemployment; (2) debt related constraints on growth; and (3) serious pressures on the trading system. Each of these in part results from, and contributes to, the others.

The deep and prolonged recession, and high unemployment, in industrialized countries has increased sensitivity to foreign competition, and induced government intervention both to limit imports and increase export, as countries try to sell similar goods in a shrinking world market. It has also slowed exports of developing countries, and weakened prices for their commodities, thus reducing their ability to earn the foreign exchange needed to repay their debts. Trade protection and subsidies, in part a product of the recession, have combined to reduce growth and raise costs, while further complicating the financial situation by limiting some countries' export earnings and thus their debt repayment capabilities. And financial constraints on the ability of developing countries to borrow have curbed their growth and thus exports of industrialized countries; this in turn has made their recovery more difficult. Exchange rate instability and misalignments have distorted trade, generated demand for subsidies and protection, and caused uncertainties which have weakened investment.

Resolving these problems requires an intensive focus on interrelationships for which the institutional structures of today are poorly suited. During the last three decades, the economies of the world have become highly integrated. Developments in domestic economies have become intertwined with those of the international financial and trading system. But, for the most part, domestic and international economic policies and institutions have not adequately taken these interrelationships into account. International trade issues, financial matters, and questions of domestic economic growth and employment are generally addressed separately, with little understanding of, or attention to, the implications of actions in one area on the others.

Turning first to domestic policy, the accepted, and indeed generally the logical, answer to high inflation is to tighten up on monetary or fiscal policy, or both, in order to reduce domestic demand. But if many countries do this simultaneously—as in recent years—the result will be a mutually reinforcing, and therefore in each country greater than anticipated, decline in growth. Indeed the fact that so many industrialized countries in the last few years have had to take tough anti-inflation measures at the same time—in part to compensate for postponing adequate anti-inflation measures earlier in the 1970's—has caused the recession in each to be deeper, and longer, than had only a few countries taken such measures.

Secondly, many of the largest developing countries—which, lest it be forgotten, were in fact the locomotives of world growth in much of the 1970's—now face constraints on growth and import demand as a result of weak demand for their exports, low commodity prices, high debts, and difficulties in securing new loans. Many are advised, in order to qualify for IMF funding and to reduce their debts, to limit consumption in order to curtail imports, and to boost exports. While this may be correct in individual cases, a world in which many developing countries together try to do this while many industrialized nations at the same time try to increase export and restrict imports, is bound to be one characterized by very slow growth and a very high level of trade friction, as each country tries to counter the actions of others. This is the case today. Everyone cannot, clearly, increase exports and reduce imports at the same time.

But if significant increases in developing country exports are not attainable in this environment, we must ask whether they can obtain financing needed to enable them to manage their debt and undertake necessary adjustments without a dramatic reduction in growth and in imports? And if they cannot, we must ask what the implications are for these nations and their trading partners? Of the sources of financing available, official development assistance has been limited by budgetary constraints in many donor nations at precisely the time when such assistance is especially vital for developing countries, and a necessary investment in the long term health of the world economy. Commercial banks are becoming increasingly cautious because of a generalized desire to reduce risk, concern over potential actions of regulatory authorities, withdrawal of regional banks from syndications and weakness in domestic loan portfolios.

This puts a particular responsibility on the IMF to provide transitional financing in order to avoid a sharp reduction in economic activity in the debtor countries while they are attempting to work down their debt to more manageable levels. The IMF, in such circumstances, must carefully balance what is necessary to achieve steady improvements in a country's debt situation against the risk that its recommendations, if too stringent, will undermine the country's political cohesion or its government, and thus its ability to take any firm economic action at all. It must be understood—although in many quarters it may not be—that the economic, political and human impact of a sustained period of negative or very low growth in most developing countries is far more serious than in industrialized countries. In contrast to industrialized societies (which have deeply rooted political systems, low population growth, and relatively generous social security and unemployment benefits), most developing countries have an only recently establishment political consensus, high population growth, and very little in the way of unemployment on social security programs. Thus their tolerance for prolonged austerity, whether requested by the IMF or resulting from borrowing constraints, is relatively low. Indeed there is a grave risk that abrupt or sustained decline in growth may weaken the very government being asked to undertake the stabilization program.

Further complicating the Fund's dilemma is that it has traditionally prescribed policies which reduce consumption and imports, and increase exports in an environment in which other economies were growing enough not to mind taking more of the exports of the debtor or selling less to it for a time. In the current environment of simultaneous recession, that is not the case.

A final illustration of the complexity of current problems involves the effects of exchange rate volatility and misalignments on trade and growth. In earlier years trade balances were a major factor, if not the major factor, influencing exchange rate movements. A large trade deficit normally led to a weaker currency, a large surplus to a stronger one. In turn movements in exchange rates were looked to as a means of reducing trade imbalances: weaker currencies normally made domestic goods more internationally competitive; stronger currencies made them less. Today, the impact of capital movements—which generally reach several billions of dollars a day—on exchange rates dwarfs that of trade balances. Capital movements respond to such factors as differential interest rates, inflationary expectations, monetary/fiscal policy mixes and political/security factors. Differences in monetary/fiscal policy mixes, for example, can lead to major exchange rate disparities which work in the opposite direction from that required to narrow trade imbalances, and thus generate pressures for protection or subsidies to offset the competitive disadvantage resulting from the disparity. Such differences, by encouraging sharp capital flows, can also force countries to defend exchange rates with measures which complicate domestic economic policy management.

The larger the portion of a country's economic activity affected by international trade and finance, the greater will be the impact on it of exchange rate movements. Thus smaller trading countries are particularly sensitive. But the United States is far from immune. The real appreciation of the dollar in the last two years contributed both to a lower rate of U.S. inflation and the deep recession we are in. This leads to the probability that U.S. recovery will be assisted by a depreciating dollar as well as to a concern that excessive dollar depreciation could restimulate inflation.

Underlining these problems, and complicating solutions, are structural and institutional difficulties.

Over the last two decades, a number of countries, particularly those in the industrialized world, have imposed on their economies myriad regulations, allowed social programs to increase at a rate substantially greater than that of GNP, and significantly augmented domestic subsidies. While many such measures may have been justifiable on their individual merits, they collectively created structural rigidities which increased costs and slowed growth in the capacity to export more and better compete with imports. They made it particularly difficult for some economies to adjust to, and take advantage of, new technologies, the growth of developing countries as competitors and markets, and sharp changes in the price of oil. And inflation and high interest rates, followed by deep recession, have slowed the very investment needed to overcome many of these rigidities.

A discussion of institutional weaknesses completes the picture. In the 1970's, despite major foreign exchange crises, dramatic increases in the price of energy, and serious inflation and recession, countries avoided beggar-thy-neighbor policies. They recognized that irresponsible actions would weaken the international economic system to their ultimate disadvantage. The IMF, World Bank, GATT, OECD and Economic Summits helped to resolve problems, limit damage, and make progress in such areas as trade, energy and development assistance.

Today's problems are generating a more defensive attitude and reducing support for multilateral institutions and solutions. This is particularly unfortunate at a time when economic interdependence has reduced the ability of individual nations to resolve problems by themselves. Moreover, the very active role being played by developing countries in the international economy—and the less dominant role of the U.S. and other industrialized nations—makes a broadening of international cooperation essential.

As world trade has slowed, and unemployment increased, the trend towards trade liberalized, which enjoyed popular support in better times, has been reversed by a series of bilateral restraint arrangements, non-tariff barriers, requirements that foreign investors use more locally produced goods or artificially boost exports, and increased use of subsidies. Such measures generally have bypassed the GATT, because its rules either did not limit the particular practice or were ambiguous enough to be discounted. Extra-GATT solutions, and GATT's difficulties in expeditiously resolving problems, have weakened that institution. More serious, however, is the inadequate support it receives from many members, which prefer to avoid the constraints its rules place on their actions and fail to make adequate efforts to strengthen it.

Likewise, major developments in the international financial arena in the 1970's tended to circumvent and weaken the role of the IMF. Borrowing by developing and Eastern European countries in the 1970's financed new investment and offset sizeable trade deficits. Such borrowing helped to sustain the growth and development of a number of countries and held up the level of demand for industrial country exports, thereby reducing the severity of recession in the OECD area. But it also led to burdensome debt obligations and permitted some borrowers to putoff instituting policies to curb import demand or shift resources to more competitive uses. As private lenders played a larger role in balance of payments financing, the effectiveness of the IMF as an institution which encourages, and supports, stabilization policies became weaker.

Finally, the OECD and Economic Summits have not been well utilized of late by member governments to resolve key issues. And a defensive "how-can-we-get-others-to-go-along-with-our-position-while-not-accepting-theirs" attitude has replaced the "what-can-we-do-together-to-improve-the-world-economy" approach which Summits were intended to foster.

RECOMMENDATIONS FOR THE FUTURE

Reversing the current deterioration in the world economy will require a sound medium term strategy.

Progress will not be achieved quickly, nor through one grand strategy such as a new Bretton Woods. Rather it requires a comprehensive strategy, a considerable degree of leadership and vision, as well as a measure of courage, because certain actions need to put national economies, and the world economy, on a sounder footing will be difficult and politically sensitive.

GROWTH AND JOBS

The single most important thing that the industrialized countries can do it to achieve sustained increases in growth and employment without the return of inflation and high interest rates, which would abort any recovery. Doing so will not completely solve international financial and trade problems, but it will improve the economic environment and thus the prospects for resolving them. A key requirement is a common effort by those countries in a position to do so to adjust their policies to achieve higher rates of growth. For the United States this means continuation of current Federal Reserve Board policies and a reduction in the large budget deficits projected for 1984 and 1985.

There has, correctly, been much attention devoted to budget deficits in this country. The key point here is that large government deficits enable governments to increase overall demand when private demand is low, in the expectation that this temporary action will "prime the pump," by stimulating new investment and new jobs, which will in turn boost private demand and thus both add to government revenues and reduce the need for future government deficits. Thus the existence of a large deficit during the current recession is far from cause for alarm. And, with capacity utilization at under 70 percent, at post-war lows, it is hardly likely to lend to a resurgence of inflation. But if large budgetary deficits are expected to be a relatively permanent fixture, which will be around even if private demand for goods and capital increases, they lead many to the conclusion that the government will be a future competitor for excessive amounts of goods and financing, which will raise the price for both—i.e. cause high inflation and high interest rates. This expectation is one reason why long term interest rates remain high; and these rates, in turn, discourage precisely the private investment in plant and equipment, and the "big ticket" consumer durable purchases, now needed to generate increased U.S. growth.

Reducing future U.S. budget deficits, along with continuation of current Federal Reserve Board policy, would on the other hand stimulate additional investment by lowering long-term interest rates and enable a continued decline in short-term rates. In so doing it would also reduce the exchange rate of the dollar, which would both improve American competitiveness and enable some other countries to relax their monetary policies without running the risk of a major outflow of capital or a weakening of their currencies.

Each country will have to decide for itself how much flexibility it has. But a common commitment to take advantage of existing flexibility can make expansionary policies a bit easier to sell domestically, particularly because countries reluctant to unilaterally stimulate their economies because of the prospect of a weakening of their balance of trade run a much smaller risk of this occurring if several act together.

Between now and the OECD's May Ministerial meeting, there needs to be an intensive exercise involving Finance Ministers, Central Bank Governors, and domestic policy officials to examine where flexibility exists. Countries with a high ratio of savings to GNP, or budget deficits due largely to lower revenues or increased unemployments payments resulting from slow growth rather than to structural imbalances between revenues and expenditures, will likely have more latitude for running stimulative deficits than those with lower savings-to-GNP ratios or a large structural budget gap. Some countries, in this context, may see an opportunity to reduce certain structural impediments to growth by, for instance, reducing wage indexation or relaxing regulations which discourage investment. Others, as noted, may be able to exercise greater monetary flexibility. The point is that just as the simultaneous contraction in demand in the industrialized democracies led to an unanticipated severe decline in their collective growth, so combined stimulative measures, even if individually modest, can lead to a stronger and broader recovery.

The need to creat jobs is particularly urgent. Unemployment today is both a massive human tragedy and a threat to confidence in market economies and the democratic systems which maintain them; in some countries the threat is to the very continuation of the democratic process itself. The problem is especially serious because the anticipated economic recovery is unlikely to significantly reduce unemployment in many industrialized democracies. First, if private employers believe, as many now do, that recovery will be short-lived, they will be disinclined to add many new employees early in the upturn. Second, and more fundamentally, there has been a major reduction in capacity in some important traditional industries; e.g. steel, autos, shoes and textiles. And the application of new labor-saving technologies in these and other sectors will reduce the number of workers required to produce a unit of output. In some cases new technologies will, by boosting overall productivity, rejuvenate declining firms; to the extent firms are preserved in business thereby, this could mean more jobs than had the new technology not been installed at all. But the net effect will, in any case, be fewer jobs in sectors which in the past accounted for substantial employment. And while many new jobs will be created in high technology sectors, their number, at least in the near term, is unlikely to exceed that lost by capacity reductions and new technologies in traditional sectors. Moreover, even accepting very optimistic assumptions about the number of new high technology jobs, many workers displaced from older sectors are unlikely to be able to move into them.

As the result of these factors, the U.S. and most other industrialized democracies will have to deal with two basic types of structural unemployment: unemployed youth who have trouble obtaining entry-level jobs and are often laid off first during slow periods, and older workers displaced by capacity reductions and technology shifts. Government sponsored training programs—particularly in an era of rapid technological change—will be needed, as will hiring incentives for the private sector and large-scale productive infrastructure programs (which have the triple advantage of meeting a major national need, creating constructive jobs, and eliminating bottlenecks which would add to inflation when growth resumes). Much has been done by a number of industrialized democracies to create new jobs. Labor and Finance Ministers, and officials, taking advantage of the good work already done by the OECD in this area, could usefully arrange—preparatory to the OECD Ministerial and Summit—a series of meetings to determine what types of programs have succeeded, what types have failed, and why. At the Ministerial and Summit the issue could then be discussed and concrete commitments made to expeditiously implement programs which have demonstrated their effectiveness.

Finally, as much of what I have said already, and will say in the remainder of this testimony, indicates an important factor in the recovery of the U.S. economy and of other industrial economies, is what happens in the world economy. The last decade saw a dramatic internationalization of the American economy. While it is clear that it remains the single most important factor in the world's economy, and thus its recovery would be an important global stimulus, it is also true that an unhealthy world economy will make sustained American growth very difficult. And it is likewise clear that without healthy economies in the developing nations, the American and the world economy are unlikely to be healthy. Today roughly 9 percent of U.S. GNP is exported. Nearly 40 percent of that goes to developing countries, including 20 percent to Latin America. Thus the current slowdown in global trade, and the financial constraints on growth in developing countries, seriously weaken our own economy. As we look to methods to promote our own economic recovery, we cannot ignore the world economy. Indeed improvements in the world economy must be one part of our own domestic recovery strategy.

FINANCIAL AND MONETARY ISSUES

There are several steps which could be taken in the international financial and monetary area which will both enhance prospects of recovery in the U.S. and in the world economy.

Flexibility is needed in the programs required by the International Monetary Fund in order to ensure that such programs are both economically effective and politically and socially sustainable. And a large (at least 50 percent) quota increase, in addition to a large GAB back up facility, are necessary if the Fund is to be in a position to provide necessary support for such programs. While each debtor nation, of course, carries primary responsibility for pursuing sound stabilization policies, the adverse international impact of an abrupt decline in their ability to borrow, import, and grow gives other nations a strong interest in the stabilization process being a smooth one supported by adequate international resources. Because of the magnitudes of some debt problems, a credible program to strengthen a country's balance of payments position may require an unusually long period of time and substantial transitional financing. I stress the world transitional because, while in some cases borrowing in the latter part of the 1970's was for consumption, in many instances developing countries borrowed to build productive capacity. Many of the larger countries in fact increased both savings and investment as a portion of GNP during that time. In many cases the decision to borrow was a reasonable one for these countries because real interest rates were, for much of that period, low or negative. Later they, as most others, were surprised by the dramatic increase in interest rates and hurt by sustained weakness in export markets. Thus many of these countries, assuming appropriate policy measures on their part and growth in the world economy, do have the capacity to repay their debts. Therefore, one should not mistake current liquidity problems, however serious, for permanent financial weakness.

It is precisely to avoid the risk of the economic collapse that developing countries require time to make necessary economic adjustments. To facilitate these adjustments, they need IMF programs tailored to their individual circumstances and substantial financial support in the form of IMF financing, new private credit, and, in some cases, concessional assistance to promote structural adjustment. Without these, reductions in growth could be so abrupt as to lead to political and social instability, and weaken or destroy any political support for sound economic measures, which would be harmful to these countries themselves, and to creditors and trading partners alike. Moreover, adequate financial support also reduces pressures to artificially restrict imports and boost exports—both of which are in any case largely frustrated by the fact that so many countries are attempting to do them at once—and thus takes some pressure off of the trading system.

By way of institutional improvements, closer collaboration among the IMF, private lenders and national monetary authorities is needed in the future to anticipate problems before they become acute and to support corrective measures at an early stage of balance of payments difficulties. Where debt reschedulings are needed, there should be a more regularized and expeditious process—before a crisis arises—to ensure that they can be conducted quickly and smoothly in order to reduce present uncertainties for both creditors and debtors. And they should be seen not simply as a one-shot way of addressing a momentary issue but, if accomplished by effective domestic policy measures and adequate international financial support, as a step toward strengthening a country's overall financial condition. Accordingly, terms should permit sufficient breathing space to give a country time to strengthen its economy, and should avoid forcing too large a repayment too soon and thereby depriving it of foreign exchange needed to import goods essential for its economic recovery.

Another institutional improvement would be an enhanced and more systematic consultative, or surveillance, process among financial authorities in the larger countries, from time to time also including trade ministers. Exchange rates misalignments give rise to distortions in trade and investment and thus to enormous domestic pressures for offsetting trade actions. In some cases misalignments result from a conscious decisions of a government to devalue in order to reduce imports and increase exports; in others, they arise from a combination of forces. In some periods what one country views as an adverse exchange rate is quite satisfactory to another; but there are times when prudent judgment on all sides suggests that misalignments have occurred. While one would find it hard to convince countries that as a regular practice exchange rate considerations should dominate domestic policy, there are times when a domestic economy is so harmed by a particular exchange rate, or when an imbalance is so apparent, that remedial action is necessary. There are also times when however strongly people may believe the market will correct imbalances, political forces will not allow the market sufficient time, and will insist on protective measures or subsidies to offset exchange rate caused imbalances; this would institutionalize another kind of distortion, which would presumably be more objectionable to those who have faith in the market than temporary exchange rate intervention or other measures to correct exchange rate misalignments.

Recognizing this, more systematic consultation is desirable to (a) identify zones for major currencies which, if exceeded, are likely to lead to major economic and trade distortions; (b) exercise surveillance over economies and exchange rates to identify where potentially troublesome disparities are occurring and why; (c) consider where corrective action is necessary and what actions are most appropriate; (d) discourage competitive exchange rate devaluations. In some cases the needed corrections may require changes in the monetary/fiscal mix. In others intervention in exchange markets may be needed. While the latter is unlikely to lead to major changes in exchange rates when domestic rates of inflation, real rates of interest or other fundamental economic factors diverge substantially, there are times when foreign exchange markets are dominated by short term, often psychological, factors. And there are times when actions of national monetary authorities inadvertently exacerbate the problem. To the extent that monetary authorities consult more regularly and agree to resist excessive volatility or divergencies, major private traders would themselves be less inclined to make decisions based on short-term factors, inadvertent actions by such authorities which work in the wrong direction could be avoided, and improper manipulation of rates could be prevented.

An integral part of the international financial outlook is the outlook for development assistance. While it is understandably tempting for legislatures and budget makers to cut foreign assistance budgets during times of domestic austerity, there is also a cost to this. Development assistance is critically important to a number of countries to help them maintain even minimal rates of economic growth and improvements in human well being. Moreover, in many developing countries the capacity to repay debt will depend on structural changes, such as improving their agricultural systems and generating additional energy production. Many cannot make such changes without outside assistance. And the World Bank, as well as the Asian, African, and Inter-American development banks, have greater influence in encouraging sound economic policy in recipient countries if their advice is backed up by financial resources which can support those countries' development plans.

IDA is particularly important because its funds go to the poorest countries, many of which, even in the best of times, have little or no access to funds which banks provide at higher interest rates. In turn, the World Bank and other institutions can help developing countries by speeding up the flow of financing to them, and allowing a larger portion of their overall program to be used for balance of payments assistance (to assist in the purchase of spare parts and raw materials etc.) where such financing is related to sound structural adjustment programs.

There also needs to be a rethinking of how to avoid excessive volatility in earnings from commodity exports. Sharply depressed commodity prices and revenues have disrupted development planning for many countries, and, in turn, adversely affected the economies of countries which export to them. In the longer run, low prices will reduce investment in new production capacity, thereby increasing the potential for sharp price increases when demand picks up. There has been much discussion of, and controversy about, this subject in the past. A re-examination of the problem in light of the experience of the last few years might lead to a better understanding of the benefits and limits of commodity agreements, how countries might go about the development of sound agreements, and whether a global STABEX, or improvements in the IMF's Compensatory Financing facility, might be desirable.

TRADE ISSUES

As noted earlier, the international trading and financial systems are closely intertwined with one another and with domestic economies. The fact that the GATT Ministerial meeting in November failed to meet the expectations of many raises the risk of a series of unilateral and bilateral trade actions. But it may also have shown a number of people the "sight of the gallows" into which, due to the lack of effort by certain countries to improve it, the neck of the trading system is being inexorably placed. The success of the recent meeting between senior U.S. cabinet members and senior EC commissioners, and steps announced by Japan's new Prime Minister, Mr. Nakasone, give some hope that a more purposeful attitude will be evidenced in the future.

But it is particularly alarming in that, unlike the period in which the last GATT Ministerial took place ten years ago, there is virtually no international concensus today as to how to improve the trading system, what should be negotiated, or even whether any negotiations should take place. Nations tend to look inward in difficult times rather than focus on systemic improvements.

What therefore appears necessary is: (a) a commitment at political level by all countries to avoid unilateral imposition of new trade barriers or subsidies; (b) an OECD and Summit commitment, broadened to include developing countries as well, to establish in the GATT a series of work programs, with ambitious deadlines, to improve understanding of the nature and dimensions of problems in such areas as agriculture, services, and investment, to determine how they can be better managed under existing GATT rules, and to decide whether, and how, more formal negotiations should be instituted; (c) an urgent effort to improve GATT's dispute settlement mechanism, and (d) agreement on a safeguard system supported by industrialized and developing nations and on a way to gradually bring under the GATT the various trade measures which have been taken outside of its framework.

The reality we must face is that in many sectors today free trade is more a myth than a reality. Well over half of world trade today is subject to some type of government support or intervention, and that figure is on the increase. The immediate issue, therefore, is not a theoretical debate between free trade and protectionism but how to prevent an escalating series of import barriers and subsidies, with countries retaliating against, or emulating, one another. In the current environment it is necessary that each nation resist the temptation to erect an economic Maginot Line around itself and be vigilant in demanding that others resist with equal strength.

At the same time we must reconcile ourselves to the reality that in circumstances of high unemployment, in order to offset the practices of others or help important sectors of their economies (particularly those which employ large numbers of people or produce significant new technologies) governments will inevitably want to provide some type of support. A key question therefore, is how to ensure that when such support is forthcoming it has relatively little distorting effect on trade and investment. For instance, what constitutes legitimate government support for research and development, and when does support become a distortion of trade? When does a government incentive to attract investment, or improvements in tax treatment for investors, distort investment decisions and trade flows? And assuming government intervention from time to time to protect sensitive sectors, for instance under safeguard arrangements mentioned above, what level and length of protection is appropriate, how can the protected sector be encouraged to adjust in order to be able to meet competition when protection ends or if it cannot ultimately compete, to reduce capacity gradually enough to avoid serious social and economic dislocations? In the latter circumstance, far more work is required to design programs that genuinely help workers and firms displaced by international competition and localities which suffer as well.

Much work is needed on these questions, which link fundamental trade and domestic policy issues. A serious excercise in the OECD and/or the GATT involving trade, finance, domestic economic, commercial and labor officials should be undertaken to address these complex issues which will have such an important effect on domestic economies and the trading system in the 1980's.

INSTITUTIONAL IMPROVEMENTS

It might be recalled that in order to establish the consensus on which the Tokyo round of trade negotiations was based, an international group of senior economic statesmen was constituted under the chairmanship of Jean Rey. A parallel U.S. group was established as well. Similar groups, with a much broader and bolder mandate, are needed today to re-examine the institutional structure of international economic cooperation in light of the experience of the last decade and recommend where improvements, including institutional changes, are needed. It should assess, in particular, the institutional implications of interrelationships among growth, monetary issues and trade issues. Working with the IMF and GATT, it should suggest ways in which adjustments to imbalances can be undertaken with a minimum disruption of growth, trade or financial flows. And it should look into ways of improving the scope for cooperation between industrialized and developing nations and for broadening the sharing of benefits and responsibilities. To command the proper attention for its work and respect for its recommendations, this group should include respected statesmen and former ministers as well as others of high caliber. A parallel U.S. group might also be set up to address a similar array of questions.

CONCLUSION

I conclude this statement as I began. The international economy is in a precarious state. It will not recover overnight. It can however benefit from a series of steps to improve growth within economies and the international financial and trading systems. The world economy in the 1970's came through an extremely difficult period. But the early part of the 1980's will present it, and those nations which comprise it, with an even more difficult task. The worse the situation becomes, the greater the risk of serious, perhaps permanent, damage to the international economic system and to economies, such as ours, which increasingly depend upon it. We have now come to understand that our growth is intimately tied up with that of the world economy and that, indeed, the developing nations, which only a decade ago were not major factors in the world economy, today are extremely important to its well being.

If we are to seriously address the problems before the world economy there must be a genuine act of American leadership. This involves neither a requirement that we carry the burden alone nor the wrongheaded notion that we can impose our will on others—in both of which we would not succeed—but leadership in forging an international concensus on a strategy for improving the ability of the world economy to serve common interests. Our success may well be the key factor in determining whether the 1980's is a decade of prosperity or one of very slow growth, and great social and political instability.

The United States and its industrial partners must make the most of the short time before the OECD Ministerial and Summit. Because of the urgency of the situation, and the requirement for high level attention to the key issues, the preparatory process for both should involve several joint meetings of foreign, finance and trade ministers. The heads of state and government must also be actively involved, and prepared to take tough decisions at home and to come to Williamsburg willing to make and implement concrete commitments. History will judge this generation of leaders harshly if, as the world economy crumbles before their very eyes, they cannot produce a strategy for progress. If it could be done in the period after World War II, can it not be done today?

Senator **Mathias**. Thank you very much, Mr. Hormats.

Let me start the questions with one for Secretary Miller. You have recommended world economic coordination. This, in essence, is what Mr. Ogden and Mr. Hormats and Senator Bradley have also suggested. How do you visualize it taking place? Is the Williamsburg Summit an adequate forum for world economic coordination? Would you have in mind something of a more premanent, more structured, more institutionalized nature?

Mr. **Miller**. Mr. Chairman, I believe that the economic summits perhaps have become somewhat counterproductive. They have become events that raise expectations for solutions that cannot be scheduled on an annual calendar, but which come only over a period of time in their own season. One of the ways we could improve international economic coordination would be to change the economic summits back to real and free consultations, avoiding pressures to issue communiques with a laundry list of prearranged staff agreements.

Senator **Mathias**. Which was, as I recall, the original purpose. I think it was suggested by Giscard d'Estaing as the place at which heads of state could get together and could consult on an informal basis freely in an exploratory way and without a lot of publicity or a lot of staff or a lot of governmental officials pressuring them for decisions at that point.

Mr. **Miller**. Bob Hormats has probably planned more summit meetings than anybody in the world, and he may disagree, but I think that we should go back to that original purpose. It would be of enormous value for heads of state to explore informally the real economic issues without the rigidity of a precooked agenda that forces them to endorse what has already been discussed, rather than to reason together with open minds.

There should be substantive consultations, I think, in preparation for summits and on a continuing basis among the ministers of finance, central bankers, and trade representatives, along the lines that Mr. Hormats has indicated. It needs to be a continuing process. It needs to be taken very seriously. It should be done not only in the G–5 and G–10 but also in the existing international institutions. It should have a crossover and coordination; consultations now may be rather structured and isolated, and that is unfortunate.

The trade representatives aren't included sufficiently in consultations about monetary issues which affect currency exchange rates, which affect trade. Not enough is being done. A great deal can be done within existing frameworks, if there is the desire and the leadership.

Senator **Mathias**. This is a point at which each of you expressed concern.

Mr. **Hormats**. Regarding the summits, the original intention was to have a frank dialog among heads of state. As Bill has pointed out, they have not done that of late.

They are now seen, by at least some leaders, as an exercise in trying to convince others to go along with their policies without giving anything to the other guy. That has made them a very defensive forum rather than a forum which is designed to strengthen international economic cooperation.

This upcoming summit, in particular, takes on a major significance because of the environment in which it will take place.

Senator **Mathias**. Speaking of the environment in which it takes place, can there possibly be an achievement of the original purpose when the American delegation at Versailles was 500? I have no idea what the other national delegations were.

Mr. **Hormats**. They were not quite as big, but some came close. That gets to the point that they have become media events with high expectations and low yield. What I would like to see happen is that there be no communique. One of the big problems in the last summit was, they spent so much time discussing language in the communique that they were diverted from achieving a real meeting of the minds on substance.

They should have one with no communique, which has not been tried before. That would be a good idea. I also think the preparation should, this time in particular, involve one or two meetings among foreign ministers, finance ministers, and trade ministers, so that they can look at these problems collectively, and so that you get cabinet-level participation in the preparations.

I would like to see, without having a communique, a genuine meeting of the minds on such issues as growth, on how to make the trading system work better, and how to improve the financial system. If they are prepared right, with a little less hype and a little more substance, they might do better.

Senator MATHIAS. Mr. Ogden.

Mr. OGDEN. Mr. Chairman, I would support that suggestion. I think, though, we ought to be careful not to expect too much of summit meetings. As you pointed out, they tend to be accompanied by a great deal of publicity and a great deal of pressure on the participants to justify their own proposals.

I would be concerned somewhat if the intent of the summit were viewed in the financial markets as one of changing many of the institutions that have served us so well. The institutions created by the Bretton Woods agreement, for example, have served us well. The reason they don't generally serve us better is that the member countries cannot really agree on a common fiscal and monetary policy.

To the extent that they could, we really wouldn't need summits, and these institutions would work very well. However, I think there is a better chance now for agreement among the major industrialized nations on a common fiscal and monetary policy which should be mildly stimulative and anti-inflationary. So, I think consultations along those lines would be very desirable unless they raised a host of expectations of a whole series of changes in the ground rules.

I think, also, the suggestions that my colleagues here have made to include trade negotiators in these deliberations is terribly important, because I think consultation on monetary and fiscal policy that ignores trade policy creates a major gap.

Senator MATHIAS. We need all three legs of that triad.

Let me turn to Mr. Ogden's statement. You pointed out that, in the case of Argentina, Brazil, and Mexico, the banks—and I presume you mean the commercial banks—will provide additional funds that are more than twice as much as the IMF's scheduled disbursements. Moreover, the amount of debt being rolled over by the banks is more than six times as much as the IMF plans to disburse.

I think that is an interesting observation. I think it is going to be important here, when we have to meet the charge, which I am sure we will have to meet, that an increase in IMF quotas is simply bailing out Chase Manhattan or bailing out CitiBank, but it does lead to a further question.

If the commercial banks—if the private sector is to do what you say it is going to do, it will involve not only the first-tier banks, but it will involve second-tier banks, and it will involve an increase of something like 6, 7, 8 percent in lending all across the whole banking sector.

What about the willingness, or the enthusiasm—let me put it that way—what about the enthusiasm of regional banks to increase their lending by 7 percent?

Mr. OGDEN. Mr. Chairman, you are absolutely right. In Mexico, which is one of the biggest country exposures, there are over 1,400 American banks involved, and their enthusiasm for further lending varies considerably.

The willingness to make further loans depends on the extent to which the banks see debt difficulties as liquidity problems and not solvancy problems, the extent that we have a mechanism in place whereby these countries have agreed to accept IMF programs, and the extent that the industrialized nations, and particularly our own, recognize the dangers of not supporting the IMF.

I think, on the whole, with varying degrees of enthusiasm, all of the major banks and some of the smaller banks will want to be part of the solution and not part of the problem. I think we are finding that in Mexico.

Senator MATHIAS. Do you gentlemen have any additional comments on that?

Mr. MILLER. Mr. Chairman, the banking community, over the years, as it has faced more workout problems, has adopted a general understanding that, in cases of difficulty, all the banks involved must participate in the solution. Otherwise, the inequities become unbearable.

If some banks decide that they are not in a position to participate, it puts the other banks in an impossible position. I think that general principle and understanding among banks is healthy. In the case of any of these workout situations, such as liquidity problems for developing countries, the IMF certainly represents part of the process of solution. It does not bail the banks out. It quite often draws them in more.

But I think, whether enthusiastically or not, banks would be more enthusiastic about a sound solution than the alternative, which is worse. It is like, as they say, "hanging focuses the mind." Well, a large workout situation does, I think, bring cooperation. Even though a bank may not be intellectually enthusiastic about a debt-workout program, I think it is intellectually sound.

Senator MATHIAS. You are suggesting it is abhorrence of the alternative?

Mr. MILLER. Yes.

Senator MATHIAS. Bob, do you have anything to add?

Mr. HORMATS. No.

Senator MATHIAS. Let me ask Mr. Hormats a question. You say the reality we must face is that, in many sectors today, free trade is more a myth than a reality, so that raises a very practical issue that governments face. They have a demand from constituents that, if they are doing it to us, we should do it to them. Of course, we had the example of that just the other day when we failed to come to an agreement with the People's Republic of China on some fairly simple trade problems and they immediately retaliated by levying restrictions on American products.

How are we going to restrain these protectionist impulses? The House of Representatives, as you know, passed the local content bill last year. I expect they will do it again this year. The Senate may very well do it. That could set off a round of protectionist activity amongst the industrial nations.

Mr. **Hormats**. It is a tough question. It affects, as I said, the financial system and all of our economies. I took a look before this hearing at the various sectors. When you go down the line, there are two things that come to mind. One is that over half of trade today is somehow regulated by governments—directly or indirectly, for example, autos, steel, textiles, agriculture, oil. As a result, each country points to the other action as justification for either a retaliation or emulation.

Now, I think the way to deal with it, and the second point, is that most of these actions have been taken outside the context of the GATT. The major trade restraint exercises—unilateral, bilateral, or multilateral—have been done outside of the framework of the GATT. This means you have got a lot of countries acting without a framework of rules which they recognize as binding on their actions.

It seems to me there are a few things that need to be done on this. One, there needs to be a major commitment by countries, all countries, developed and developing, to resist new trade barriers and new subsidies. That, of course, is easier said than done because these commitments in the past have been honored more in the breach than in reality.

Second, there needs to be a genuine effort to get the exercise of multilateral improvements going again. The GATT ministerial meeting, as you know, was a very major disappointment to many. And the fact that that did not work has unfortunately led many people to believe that unilateral and bilateral actions are now permissible.

We really ought to get the GATT process on track again, in several ways. One is to get the work programs going in a more ambitious way, covering agricultural issues, investment issues, service issues and a host of others. And somehow there has to be an agreement relatively soon on the so-called safeguards mechanism, which is the mechanism countries can use under the GATT to deal with disruptive imports. Also there needs to be some way of trying to pull within the GATT all these things that are being done now outside of its context.

But the plain fact is that the debate over the next couple of years is not going to be between free trade and protectionism. As I say, free trade is half breached already. The real issue is going to be how do you prevent a cascading series of new measures? Governments are going to intervene to a degree when they have high unemployment and they face problems abroad. The real key is to make sure that that intervention is not distorting of trade and investment. There will be incentives, for instance, for research and development. That is government intervention. There will be investment inducements and incentives. There will be a whole host of these things.

If governments are to intervene, that type of intervention is probably better than erecting barriers at the border or providing massive subsidies, but it is only better if governments are willing to enter into some degree of understanding on the threshold of R&D incentives and the threshold of investment incentives. When do they become a legitimate means to help a domestic industry and when do they cross the barrier to become actions which distort trade and distort investment.

It seems to me that type of issue, which hasn't been probed very much, has to be looked at. So we have to deal with the aggregate problem of resisting new subsidies, resisting new protection, as well as the specific problems of getting the trading system moving and finding ways by which governments can intervene constructively with the sorts of measures I have talked about, without distorting trade.

It is a tough agenda. It is not going to be easy to control; it is going to be very hard to control.

Senator **Mathias**. It is a tough agenda.

Mr. **Hormats**. And we have not moved very far on that agenda, I would point out. We need to use the OECD meeting and the summits together.

Senator **Mathias**. You have been in the heart of this problem for the last several years. Are the institutional tools adequate?

Mr. **Hormats**. The GATT today is in a period of testing. It has not proved to be very effective in dealing with some of these issues because the rules are out of date in many cases, and in many cases the dispute and settlement mechanism is rusty. The worst problem, however, is that many countries simply do not want to be bound by the GATT rules and therefore have not made the major efforts needed to improve the GATT.

As a result, there is a tendency to blame the GATT. The GATT is really a mirror. It is a mirror that reflects the intentions and the commitments of the countries that are members of it, and they haven't done very well by it.

Senator **Mathias**. It is a very human thing to want to get the benefit without bearing the burden.

Mr. **Hormats**. That is right, benefits without responsibilities.

Senator **Mathias**. Gentlemen, do you have anything to add to that subject?

Mr. **Ogden**. Mr. Chairman, I fully support what Bob Hormats just said. I think it was a French official that said that the reality is we are no longer talking about free trade; we are talking about how much protectionism we will have.

I think it is critically important that the United States, as the world's largest economy and undoubtedly the example for the rest of the world, continue to stick to its principle of free trade. Even though we have to make adjustments from time to time. For example, we may have to consider the question of how much money goes into R&D to help an industry. We may have to consider the question of exchange rate policy when the dollar is overvalued against the yen. But I think if we depart from our basic principles we will find that, without the leadership of the United States, the whole world will increasingly turn to protectionism.

Senator **Mathias**. Senator Proxmire.

Senator **Proxmire**. Mr. Chairman, I want to congratulate you again on a very fine panel. As you may or may not know, Federal Reserve Board Chairman and Treasury Secretary Miller and I go back a long way. We have not always seen precisely eye to eye on every issue, but I have always really admired you, Mr. Secretary or

Chairman. You have certainly served this country with great devotion and ability, and I think you have done a fine job today as you always have.

As you know, Mr. Chairman, I am in the same dilemma you are, and I sympathize with you completely. This is an example of the excellent panels we have, but somehow the people that are expert in this area, concerned, informed, come from an area where at least there is a perception of a conflict of interest.

Wall Street, after all, the big banks, they are lenders. They take part in this, and obviously they are going to testify on the basis of the way they see it through their eyes, and they testify with complete integrity. But there is a tendency for there to be a perception at least that it is somewhat self serving. For that reason I am going to ask some questions that may seem a little hostile, but I think they have to be asked.

Mr. Ogden, in previous bailout or rescue operations or emergency loans or adjustment loans, whatever you call them, such as New York and Chrysler, in which Mr. Miller is particularly expert, the Federal Government required financial sacrifices from those who stood to benefit from Federal assistance. As a matter of fact, Mr. Miller insisted that the banks make those sacrifices and was the principal mover to make sure that they did. They were required to stretch out their loans on favorable terms.

What kind of financial sacrifices do you think are appropriate for the banks who do stand, after all, to benefit from an IMF loan package for LDCs in financial trouble, and how can Congress assure itself that an appropriate sacrifice will be required?

Mr. Ogden. Senator Proxmire, I think it was not only Bill Miller who was cognizant of the need to sacrifice, but also the Congress, and I think you were one of the leaders in insuring that New York City accepted some conditions before they got the money, which is I think was very desirable.

I think the point really is that we should not be looking for someone to punish in this. The mistake—if there was a mistake—that everyone made, is that no one really appreciated the depth and duration of this global recession. If that is true, and I am convinced it is, there is not a villain here to punish.

In fact, the banks today are losing flexibility to manage their loan portfolio. I think that is a sacrifice. I met with some bank stock analysts the other day who explained to me that bank stocks are not really participating in the runup in prices that some industrials are enjoying because the banks have international problems.

So I think the banks are making sacrifices. I think the banks recognize that there is a very responsible role for them to play here. They recognize that the present debt problem is a liquidity problem. And they have been instrumental in working with the IMF—much more closely than in any of my 30 years of banking. I think the IMF is providing enormous leadership here. Therefore, I think the thought of looking for someone to punish is really counterproductive.

Senator Proxmire. Mr. Ogden, I certainly gave the wrong impression with my question. I have no intention of feeling we should punish anybody, but after all, there is a burden that has to be borne, and it is a question of who bears the burden and in what proportion.

For example, under the Mexican loan package, private banks are expected to loan an additional $5 billion, as I understand it. Two billion will come from official Government lending agencies, and $1.6 billion from the IMF. Why cannot the IMF reduce its degree of financial participation and require the banks to pick up the slack?

The main role of the IMF is institutional; that is, requiring the borrowing government to embark upon an economic adjustment program. Why could it not achieve that end with substantially more modest loans?

Senator **Mathias**. Senator Proxmire's question reminds me a little of the story from the Bible. Remember, the Lord did not finally require that Abraham sacrifice Isaac on the rock. He only required credible evidence that he was willing to do it. [Laughter.]

Senator **Proxmire**. I don't know why you talk about punishment and sacrifice, if these are basically good loans and they are profitable loans, and they have been—we had testimony to that earlier from Senator Bradley, and no one has denied it.

I am not asking for a sacrifice. I am just asking for the bankers to do what they do so much better than Government ever does, which is to lend money. That is your job. You are expert at it. We are not.

Mr. **Ogden**. As I said, Senator, on a voluntary basis, the banks are providing in those three countries I mentioned more than twice as much new money as the IMF is going to disburse this year and rolling over more than six times as much.

Yes; I think there are varying degrees of enthusiasm in doing this, but essentially it is voluntary. If we start to mandate that the banks do something, it doesn't become voluntary. I think then many banks would begin to think this is just something the Government wants, and the whole spirit of a responsible, cooperative effort would begin to fall apart.

The path that we have taken, which is the banks working with the IMF and the borrower countries, the negotiation of IMF agreements, and an increase in the Fund quotas, is a process that I think is working and working quite well. I am quite optimistic about it, but it is not in the bag yet.

Senator **Proxmire**. Let me try to get at it another way. I want to quote you now. You say, "The assumption that tighter administrative controls over foreign lending by banks would have prevented the present debt problem is without foundation." You go on to say, "It is quite true that the banks failed to forecast the prolonged severe recession that has been the primary cause of the problem. But so did the regulatory authorities." That is your quote.

Now, would not country risk limits based on percentage of capital that can be loaned to one country, would that not have prevented the present problem by limiting the exposure of banks?

Mr. **Ogden**. Senator, we do have a form of country risk limits.

Senator **Proxmire**. By firm, not by——

Mr. **Ogden**. Put in by the Comptroller of the Currency in terms of limitations as to how much we can lend to a single borrower as defined by a means and purpose test. I do not really think tightening that up is the answer.

Senator **Proxmire**. Do you think it is sound that the 10 biggest banks have loaned 130 percent of their capital to Argentina, Brazil, and Mexico, on the average?

Mr. **Ogden**. Senator, I think given that the problems these countries are having are liquidity problems and that they are soluble problems—unless one assumes that we are doomed to a decade of no economic growth—I think it is sound.

Senator **Proxmire**. How would banks which find themselves with high risk loans be required to set up a separate and identifiable reserve for those loans?

Mr. **Ogden**. We already have a reserve for all of our loans. I am not sure I really understand the purpose of carving out some sort of a special reserve for one type of loan rather than for another type of loan.

Senator **Proxmire**. You see, the problem here, it is so different from ordinary loans because there are international institutions to get involved. There are governments that get involved. And you are not assessing a loan to a particular firm, I presume, in Mexico the way you would a particular firm in Wisconsin or in Kansas or in this country on the same basis because it is different. You do have both our country and the foreign country involved in an entirely different way.

Mr. **Ogden**. As a matter of fact, at least at Chase we would assess them exactly the same. A bad loan in Mexico to a private firm is no better or no worse than a bad loan in this country, and we should take similar action. The loan should be written down, and the banks are doing that.

Senator **Proxmire**. Supposing we prohibited including in an income fees derived from extending the terms of risky loans and applied the fees to reducing the principal of loans. The Wall Street Journal had an article not long ago in which it said that there was substantial profit, that it cost far less to actually extend the loans than the fees that are charged by the banks, hundreds of millions of dollars less.

Why should that not be applied to reducing the principal?

Mr. **Ogden**. Well, I wonder whether the Government really wants to take onto itself the task of making those judgments as to whether interest received on these loans should go to reduce the principal or go into income.

It seems to me that what we are talking about is basically whether government is beginning to make the decisions that each individual bank——

Senator **Proxmire**. The Government should not make any more decisions than necessary, but the Government is being asked to be involved here to the tune of billions of dollars. That is what all of you gentlemen testified to. You say we should do it, and if government gets involved to the extent of billions of dollars, we ought to provide safeguards. We ought to provide terms, it seems to me.

Mr. **Ogden**. Well, you are absolutely right, Senator. I think we are asking government to get involved through the IMF, because I think the IMF is a centerpiece for this effort. And I do believe that quotas are insufficient. They have, as Senator Bradley said, about $40 billion worth of resources now, including the General Agreement to Borrow. They have only about $33 billion in quota resources, and they have used up about $24 billion of that. That leaves $9 billion or possibly slightly more than that available. And that is just too small a margin of error.

But I view it as a cooperative effort. The involvement of government in this problem is to provide liquidity, to increase the Fund quota and not to look, it seems to me, for a villain in this drama.

Senator PROXMIRE. Mr. Hormats, you suggested that we have a very difficult situation here, and I must say I agree with you. It is so hard, because if we follow the policy that I am inclined to follow, and I know you and the other members of the panel are, which is to follow a restrained fiscal policy, cut the deficit, continue an anti-inflationary monetary policy, and do our best to try to improve our balance of trade, and other countries do the same thing, the recovery is going to be slowed down greatly.

Long term is the right policy. Short term is very hard to apply and expect to get the kind of recovery we so urgently need.

It seems to me you put the situation very well. You seem to counsel moderation. But I am still a little puzzled as to what we do about this except to justify almost anything we do on one ground or the other.

Mr. HORMATS. Well, in the traditional Keynesian sense a large deficit is desirable to stimulate growth. So the present deficit is not a problem. It is the future which troubles me. A reduction of budget deficits in the outyears—1984 and 1985—would be a stimulus to growth, because the key problem holding back the U.S. economy now, in my judgment, or at least one of the key problems is very high long-term interest rates. To the extent we can reduce the expectation that there are going to be large budget deficits in future years, those long-term rates will decline and a greater degree of investment in big ticket consumer items and plant and equipment will be stimulated.

And that is particularly important at this moment. It is particularly important because we have today a capacity utilization which is the lowest we have had since World War II. In the face of very low levels of capacity utilization and very high long-term interest rates, the investment climate is very weak indeed. And to the extent we can get long-term rates down, it will give somewhat more inducement; and that way you will get the pump primed a little more quickly.

What in any case, I fear we are going to have, as you pointed out, Senator, very large trade deficits. If there is even a moderate rate of growth in 1983, we are going to have very large trade deficits.

Senator PROXMIRE. And if the developing countries follow the advice we expect the IMF to give them, we are going to have even larger deficits.

Mr. HORMATS. Absolutely. And that is why it is particularly important, in my judgment, for the IMF programs not to require excessive austerity. Because it is that very austerity which goes to the point you are raising. If you ask too much austerity in too short a period of time, you force countries to reduce their imports and push more exports onto the market that will not take it. Therefore it is a remedy which in times of general growth is correct. In periods when everyone is growing very slowly or having negative growth and everyone is trying to increase exports and reduce imports, expecting that that medicine will work is simply, in my judgment, overly optimistic. And therefore, I think the IMF in these countries needs to encourage a slower adjustment process than in the past, because of these conditions.

We hurt ourselves if these countries go through wrenching, abrupt reductions in demand. In addition, the political instability factor is a key.

Senator PROXMIRE. I am very tempted to get into questioning on fiscal policy and monetary policy. I am not going to do it because time is limited. But let me ask you, Mr. Hormats, the International Monetary Fund has the authority to meet its needs by borrowing directly in the private market rather than through its members. Why would it not be feasible for the IMF to meet all or a portion of its needs from private sources?

Would not the IMF be in a special position to borrow on reasonable terms from those financial institutions that stand to benefit most from the IMF adjustment program?

Mr. HORMATS. I am a believer in the IMF's going into the market and borrowing some. I tend to think the IMF can borrow. I do not think that is a substitute for a quota increase, however. I think a quota increase is necessary for three reasons.

One is the general confidence factor. Two, if the IMF has more money, it can provide more to countries and therefore reduce the requirement that they abruptly curtail demand. And I think the more the IMF has available to it, the more flexible it can be.

Senator PROXMIRE. Are you saying that in addition to the amount that it is going to borrow from the Federal Government, it needs even more than the leverage that will give to borrow from——

Mr. HORMATS. That was my third point in fact; that I believe that it is going to—it should be able in extremes to borrow from capital markets. It does have, as you know, the authority to do so; and I would have no problems at all with it doing that. It does need its own substantially increased resource base, though.

Senator PROXMIRE. You believe it needs the 50 percent quota increase?

Mr. HORMATS. I think it needs at least a 50 percent quota increase—well over that if possible.

Senator PROXMIRE. Let me ask you about that. That would give the IMF at least another $16 billion in usable currency plus another $10 billion under the General Agreement to Borrow. That is a lot of money by any standard. It could finance an additional 15 loan packages on the scale of the Mexican agreement.

Why is so much money required to maintain confidence? Do you really believe we will see 15 Mexican-type bailouts over the next several years?

Mr. HORMATS. I believe if the world economy improves we will not, and I certainly hope we will not. But we are dealing with a real problem and a psychological problem.

Psychologically, the absence of an adequate amount of IMF funding to do the job in a difficult situation raises the risk factor enormously. And second, the real problem is that there just may well be situations where more money is required for countries that already have IMF programs, and for problems which may come along. I would not want to predict that there will be, but I think there is a risk—it is like having insurance. We hope we will not have to use a few million dollars worth of insurance, but it is good to have; and that is where I would come down on this.

It is good to have. The risks of not having it, the risks to the stability of the system which would feed back to our own economy, are so enormous that I would much prefer to provide the money and hope that we do not need to use it rather than not provide it and then face an emergency situation where a country is scurrying around to get the money, and the confidence factor and the economic situation deteriorates in that period.

Senator MATHIAS. Does Chairman Miller want to comment on that?

Mr. MILLER. Let me make one point. I believe the IMF has borrowed in the past. When it seeks substantial borrowings, quite often it is borrowing from governments or central banks rather than capital markets. This may raise some political issues in terms of the lenders wanting greater control over the IMF. It is in our interest not to see an erosion of the U.S. position in the IMF, which is slightly over 20 percent, which gives us a very important voting right. We should not want to reduce our share. That should not deter the IMF from borrowing in capital markets. The IMF could certainly consider this.

Senator PROXMIRE. You say in the best they borrowed from central banks, but you see no reason why they could not borrow——

Mr. MILLER. Continue to do the same, being careful of the political issue.

Senator PROXMIRE. They would certainly be a completely credible borrower, would they not?

Mr. MILLER. And second, as far as the amount of the quota increase, we must remember that these increases come infrequently, and they involve a difficult political process of obtaining approval from about 150 nations. And so having an adequate increase now instead of having continuing uncertainty is desirable.

I also would point out that the quota increase does not tie up resources unnecessarily. The U.S. contribution to the quota is a letter of credit which would be called upon only if there is a need for the Fund. So we are not tying up funds that are idle. By approving its quota increase, the United States is only saying that it stands by to take its pro rata share if the IMF calls for funds. So I think the process of having an adequate safety arrangement, and having it well in advance of need, is desirable.

Another point is that the resources of the IMF have steadily declined in relation to the volume of world trade and finance, so they are becoming a smaller and smaller share. If in 1950 the IMF resources were relatively larger with less problems, it seems logical that today such resources should at least be improved somewhat, from their much lower base, as an insurance policy. It is true that when the economy of the world grows, the IMF may be able to operate with a smaller percentage of resources in relation to world trade. But the relationship has eroded to too low a base and should be improved.

Senator **Proxmire**. Chairman Miller, let me follow up along that same line with a little different angle.

Why is it necessary to authorize the $25 to $30 billion of IMF lending authority all at once? In other words, why would it not be prudent to phase this commitment in over the next few years? For example, none of us can see the future very accurately. What would happen if there were a dramatic turnabout in the balance of payments deficits to the LDC's?

Should that occur, is there not a danger that all that lending authority sloshing around in the IMF would be used to make inflationary loans to the LDC's? What discretion does Congress have should the international financial situation change for the better? If it changes for the worse, we can always come up with additional fundings.

Mr. **Miller**. If it changes for the worse, I would fear that parliaments may not act rapidly enough to replenish the resources. That is the difficulty. Parliaments do not act instantaneously, and there are parliaments of about 150 nations which would have to, or at least the majority would have to approve any quota increase in an emergency situation.

On the other hand, if we have quotas established only on a contingency basis, and availability would require parliamentary action, then we have a real problem if an urgent need arises.

Now, your point is: Could the IMF become somewhat less responsible in its administration and make inflationary loans. Historically, the IMF has been a very responsible body. Its conditionality has been criticized as being too harsh rather than too lenient. The control through the Board of Governors is effective and responsible. The largest vote is held by the United States and there is strong voting power held by the OECD countries. The strong preference of the United States and the OECD countries to avoid speculative and inflationary lending is an adequate restraint.

I believe the system works. Like any other international institution that needs to be ready in the case of difficulty, it would be preferable to have the firefighters ready to go if the need arises, rather than hope to put together a fire brigade in case there is trouble.

Senator **Proxmire**. Let me ask you one final question, if I may, Mr. Chairman.

Mr. Hormats, a previous witness, whom you know I am sure, Felix Rohatyn, has testified that there is no way the LDC's can ever repay the staggering debt burden they have built up over the last several years. I think Senator Bradley said somewhat the same thing this morning.

Mr. Rohatyn argues that if they are to recover, the banks must stretch out their loans over a much longer period and reduce their interest rates. How do you respond to that analysis of the problem?

Mr. **Hormats**. First of all, the issue of the moment of whether or not the banks will ever repay is not the fundamental issue. The issue is are the debt levels manageable so that they can service their debt in a timely way. That is, it seems to me, the more immediate issue.

Senator **Proxmire**. That is startling. You say whether they can repay or not——

Mr. **Hormats**. Let me divide the issue into two. The immediate issue is can they service debt on time, and that, it seems to me, is today a liquidity question in large measure.

The second and a longer-term issue is can they repay. And I would say the answer is yes, they can repay their debts over a period of time. This is not to say they will be debt free—anymore than the United States is—but that they can repay debts in a timely way. Some will take longer than others, but let's go back to the period after World War II.

There was a lot of debt extended to countries whose economies were destroyed by the war. They did not have any productive capability at all. And those countries, over a period of time, and through good economic policy and through wise borrowing have paid their debts. Some are now, in, or have been, surplus countries. The developing countries, many of them, borrowed not entirely for consumption but to build productive capabilities.

Let's look at Brazil, a good case. Sure, they had to borrow to a degree to offset the oil price increases, but they also borrowed to build very substantial energy projects and very substantial projects that are based on their desire to increase productive capability. And my judgment would be that given a reasonable performance of the world economy and given sound domestic policies, they do have the capability to repay.

Senator **Proxmire**. But to safeguard that, do you think the banks should stretch out their loans over a longer period and reduce their interest rates?

Mr. **Hormats**. To stretch out the loans? They are, in effect, stretching them out now through the reschedulings, and many of the loans are, in effect, rollover loans anyway.

Senator **Proxmire**. Do you feel the stretch-out is adequate?

Mr. **Hormats**. You would have to go country by country. But I think generally, in answer to your question, it is adequate. Maybe they could do it a little bit more, but I think they are, in effect, doing it now. They are doing it because the process of rollovers and rescheduling that Bill Ogden talked about is going on.

Senator **Proxmire**. How about the rates? Can they come down?

Mr. **Hormats**. Well, that is a difficult question. These banks borrow money at a given rate. They have to pay for the money they borrow from people, and they have to charge an amount over the amount that they borrowed the funds for. So it is very hard, with domestic interest rates remaining relatively high, for them to pass on money at a lower rate then they borrowed it for. That is the fundamental constraint.

Senator **Proxmire**. I understand the free market contradiction here if you ask for lower rates. On the other hand, some of these countries feel, I am sure, that they are over a barrel. They do not have much choice. And if you say fundamentally they are sound, they are going to be repaid, it seems to me it is awfully tempting for a banker to keep those rates high. When rates come down he is in the driver's seat where he can do it.

Mr. **Hormats**. Bill Ogden can speak to that point better than I. If you ask the broader point, should the system as a whole try to extend repayments and get rates down, I think the answer is yes. To the extent one can provide a little bit more security through having a mix of private funding and IMF program, the risk factor is somewhat less in the longer term and, therefore, I think that will be built into a lower rate structure.

Senator **Proxmire**. Mr. Miller.

Mr. **Miller**. Senator Proxmire, I think you have raised a very important question. I would like to take a few minutes to try to talk about it in a little deeper way.

First, what is the nature of debt, when we talk about debt and whether it will be repaid. I would like to start with a bank like the Chase, or a corporation—a manufacturing corporation, if you wish. The source of capital is first from common equity—investment by shareholders—that has no fixed obligation to be repaid and no fixed obligation to pay dividends or interest. But the capital of the corporation may also be made up of debt obligations. In the case of a bank, obligations may be in the form of securities or many sorts of liabilities that are acquired by the bank to provide its total capital.

A business corporation may borrow funds for either short or long terms. If a bank or a corporation prospers and has adequate earnings, it will pay back individual lenders but it will incur new debts in relation to its own earning capacity and in relation to the coverage it provides for servicing the debt. Over time, over a 10-year period, let us say, a successful corporation will not pay off its debt. If it has grown, it will actually have larger debt than it had 10 years before. But the fact that its expanded earnings give increased coverage to handle debt service, makes it a credit-worthy borrower. It pays back individual lenders and borrows from new lenders on terms that are current in the marketplace at the time.

The same things are true of the United States Government. It is not intended that the United States Government will pay off its debt. It is intended that it will continue to be credit worthy with the capacity to tax and to raise revenues for its good and useful purposes, including many that involve long-term capital investments. As long as that is true, the United States Government will pay off individual lenders but it will incur new debt in the marketplace on current terms and conditions.

So I think we should not focus on the idea that the ultimate object is to "pay off debt." If we paid off all the debt of the world, the economy of the world would collapse, because the capital that supports the world economy would have been withdrawn. That would never work.

What we want is to have the debt of an individual nation reasonable in relation to its capacity to service that debt. That is what we should be working toward. And if there are adjustment processes and if the world economy recovers and grows, and thereby the income-generating capacity of a Mexico or an Argentina improves, then such a nation's capacity to service its debt in a normal way, to pay off some lenders and to obtain new loans on open market terms, would work quite well. And this is our goal.

Senator **Proxmire**. Just to interrupt, Mr. Miller, I think that is an excellent analysis. I think your response is exactly on target and right, but I do not think that is what Mr. Rohatyn or Senator Bradley would have in mind.

They recognize, as you say, that the problem is whether this debt is becoming so burdensome, so heavy, so excessive, even in relationship to a growing GNP which these countries enjoy, is too much.

Mr. MILLER. Let me go on just a few moments. I think this is so important, and I want to comment on both Mr. Rohatyn's and Senator Bradley's points.

In the first place, if a corporation or a government is unsuccessful and it is not able to generate cash to service its debts, then you will have a bad debt and the lender or lenders will have a loss. All lenders try to avoid losses, and when they cannot avoid bad debt losses, they at least try to keep them as low as possible. In every year's operation of a bank, there is a certain charge to income for uncollectable loans or for reserves against loans that are nonperforming or may become uncollectable.

I agree with the implication of your question, Senator Proxmire, that there is nothing wrong in a rearrangement among creditors, or in an IMF program for a country, with an arrangement whereby all the constituents bear the burden and risk of adjustment.

There is some risk for the citizens of a country that have to suffer austerity. There is some risk for IMF shareholders who have to put up funds. There are risks for banks. It is appropriate, not as a matter of mandate, but as a matter of negotiation, that the willingness of IMF to enter a program may be conditional upon concessions from banks as well as from countries to make the workout successful.

I think that is perfectly proper, and if it means stretching out, if it means other concessions in certain cases, so be it. I think that is consistent.

Now, a stretchout of payment is almost essential in all of these cases. Interest rates may have to be adjusted, not because of meeting the marketplace, but because of ability to pay. For example, in the Chrysler situation banks agreed to make loans with lower interest for awhile in order to help the company heal so that it could pay its debts in the long run.

Now, if you talk about a mandate that cash interest paid should be used to reduce principal rather than be included in bank income, in a way you are getting into an unnecessary complication, because money is fungible. If reserves are required against bank loans, they are taken from bank income, whether the bank has already reported interest received as income or not. All reserves in effect come out of the income statement of the bank.

So, whether a loan is written down or reserved against by applying interest received or by deduction from overall income of the bank, the effect is the same. Money is fungible.

Now, to continue for a second to the very important point—should the banks reduce the interest rate on loans to countries now facing financial difficulties, and stretch these loans out over 30 years, and should the U.S. Government then buy these loans, either securities reimbursing the banks for the full principal amount and having the United States absorb the losses or reimbursing the banks at market value and having the banks absorb large losses. I would say absolutely no. That would just not make sense. The banks should take each case on its merits, working out a debt-repayment program as appropriate in the circumstances, in cooperation with international institutions where necessary. In most cases, because of the prospects for improvement, the loans will be made good over time.

If, in some cases, there are losses on bank loans the banks should suffer those losses, not taxpayers. I'm sure the banks are willing to meet their responsibilities in this regard. I do not think they are asking for a bailout, nor should there be such a bailout.

Mr **Ogden**. Senator Proxmire, I would like to address a number of issues that you raised and which I think are terribly important.

One is the question of concessional interest rates. There is no doubt that the burden of this debt is an onerous one for many of these countries, but, if you put yourself in their place, what would you rather have? Would you rather continue to bear that burden in the hope that real interest rates will come down as we get some economic growth in the world and reduced inflationary expectations, or would you rather have a concessionary interest rate which, in effect, will mean that the capital markets of the world would be closed to you for an inordinately long period of time?

Most countries—and when we are talking about these less-developed countries, we are not talking about 150 of them; we are talking about eight or nine that are middle-income countries, semi-industrialized—they want access to the world's capital markets.

My feeling is that the Brazilians, in 2 years, will convince themselves that they never had a problem. Argentina expects to have a balance-of-trade surplus this year. The last thing in the world I would think those countries would want—the major countries, not the countries that are basket cases, but the major countries which constitute the bulk of the debt—would be some sort of concessionary lending which, in effect, would write them out of the world's capital markets for the next decade. And, if that were to happen, the burden on the United States to replace, at least in part, those capital markets would be enormous.

If I could turn to another question that you raised. Some of the proposals for a reconstruction finance corporation of the world, as I understand them, tend to contemplate the banks' declaring all of these loans in default and writing them down, assuming that they are permanent problems, which they are not, and then some sort of Government agency or some sort of governmental body buying preferred stock of all of the major banks.

It seems to me that this is an extreme solution to a problem that doesn't exist. And, second, I wonder if the Government wants to play the role of investor of last resort, as I think Bill Miller was pointing out. We do not need an investor of last resort. If the banks have made bad loans, that should be written down; the banks should take the punishment and write them down; and we are prepared to do so, sir.

But, we do not think these loans in these countries are bad loans. We think there are temporary liquidity problems, and extreme solutions to problems that do not exist seem to me to be very counterproductive.

The third point I would like to make, Senator, concerns three critically important questions that I think you raised about the IMF. I would like to say a brief word on each of them. The first question I think you raised was whether they should go to the private markets.

Senator Proxmire. The IMF?

Mr. Ogden. The IMF. I think every major investment bank in the world and many of the world's leading commercial banks have all made presentations to the IMF, trying to help them go to the private markets as investment bankers. And, I think one might argue that, to a modest extent, that is something that they should consider.

However, I think we have to be mindful that the IMF has never been contemplated as the world's lender of last resort. The lenders of last resort are the central banks of each individual country. The IMF was contemplated at Bretton Woods, and I think it still is contemplated, as a cooperative arrangement, to provide a limited amount of international official credit through a series of quotas by it member countries—never as a lender of last resort.

And I think there is a feeling—and I know the Managing Director of the Fund has this feeling because he has resisted the temptation to go to private markets—that should the IMF go too much to private markets, it could set in motion a spirit within the IMF that is completely contrary to the reason it was founded, which was to create a cooperative effort of member nations limited by agreements as to quota contributions.

The second question I think you raised is, How much of a quote increase is needed? We have carefully considered that. When the French proposed doubling the quota back in the early fall of last year, we took a very hard look at that, and I think the answer is, No one really knows.

I think one can say that there are general parameters, depending on what your outlook for the world is over the next 2 or 3 years, that would tend to argue that a 20- to 25- or 30-percent increase is cutting that margin of safety much too fine. A 50- to 60-percent increase would allow a margin of safety. And one might well argue that we should have a little margin of safety here, given the time it takes in an emergency situation to get a quota increase.

By the same token, I think there is a feeling that an inordinately large quota increase might tempt the Fund at some time to seek to modestly change the role of the IMF from a mechanism of temporary adjustment to something else. I find it hard to visualize this while Jacques de Larossiere is Managing Director, however. So I think it is a question of finding a balance.

I do not know what is exactly right, but I think it would be better to err by giving a little too much rather than too little. There is, as Bob Hormats mentioned, a psychological issue. If you are a bank with a run on it, the best thing you can do, if you can do it, is to stand there and shovel out the money with a smile.

Senator Proxmire. Thank you very much. Thank you, Mr. Chairman.

Senator Mathias. I have a couple of questions. Mr. Miller talked about the reasonable ability of a nation to service its debt. What criteria for reasonability do you have?

Mr. Miller. Quite often it is related to the export income—foreign exchange earnings—of the nation as a very good measure. What the country is able to earn abroad, and how that relates to its debt service needs, will be a good indication of credit worthiness. Of course, it is more complicated because it also depends upon the country's balance of payment position and its capital flows.

I think there was some material submitted to the committee with a number of tables indicating different measures. Generally, most people look at the export earning capacity of a nation as one of the most critical factors.

Senator **Mathias**. Is debt to GNP of any value?

Mr. **Miller**. In that context, no, because you are talking external debt, and we usually think of debt—all debt, as a matter of fact, has to be related to ability to service it. Our debt in relation to GNP in the United States—and this is probably very strange and people will find it hard to believe—since World War II, the aggregate debt in the United States, public and private, in relation to GNP has been virtually constant. At the end of World War II it was held much more heavily by the Federal Government as a result of borrowing during the war, and the percent of government debt has declined steadily as a percent of GNP, and private debt has gone up as a percent of GNP.

Recently, in the last 2 years, that has begun to reverse, and the Government debt, to my very great sorrow, is creeping up as a percent of GNP and thereby, private debt is being squeezed down. That is hurting our economy. We are draining away the savings of our Nation for government expenditures, instead of letting it be used to create the productivity and jobs that we need to get our economy going.

Senator **Mathias**. While we are talking in these fundamental terms, Mr. Ogden, in his statement, noted that our difficulties reflect a severe liquidity problem, not a problem of insolvency. What are the signs of moving from a liquidity problem to a solvency problem?

Mr. **Ogden**. Mr. Chairman, when you are moving toward a solvency problem you are really beginning to question whether the long-run productive capacity of the country, under any reasonable long-run economic scenario, is sufficient to allow that country to service their debt over time. On that definition, these are very clearly liquidity problems and not solvency problems.

Bill Miller mentioned that the debt service ratio is one of the rough tests that lenders use. By debt service ratio I mean the ratio of debt service obligations to exports of goods and services. Back in 1973 to 1977, the debt service ratio of the non-oil LDCs was about 14 percent. Even in 1978 to 1980 it only went up to about 18 percent. But in 1982, it went up to almost 26 percent, and it was not only the result of higher debt-service payments but also that their exports had gone down.

It would be hard to visualize a world of such stagnation, protectionism, and no growth that the capacity of these countries to service debt would continue to deteriorate the way it has in the last 2 or 3 years. And that is really why I do feel it is a liquidity problem and not a solvency problem.

I think another issue, if I might just take one more minute, Mr. Chairman, is that a country does not take itself out of the Western world's trading system by defaulting on debt simply for economic reasons. No country would say I will not accept a tough Fund agreement, or say I want concessions on debt and if I do not get them I will take my country out of the Western world's trading system and look to Poland, Cuba and the Comecon countries as an economic model for economic growth.

That only happens for ideological reasons, which is why countries have been willing to accept these Fund agreements, and why they are not thinking of abrogating debt, and why they are making an effort to pay it. There is a problem only if these Fund agreements, as Senator Bradley and I think Bob Hormats mentioned, are so tough that they become self-defeating. Senator Bradley's example of the German reparations after World War I is relevant here. It is a question of finding a balance between good fund agreements that can be lived up to with some economic growth over the next 5 years or those that would give them a felling of hopelessness, which would bring all the idealogues to the fore.

So I think your question of when does a country go from liquidity to solvency really gets down to whether the workout agreement would be so tough as to create a feeling of hopelessness that would bring idealogues to the fore, or whether it provides an incentive to stay within the Western world's trading systems and maintain access to the free world's capital markets.

These countries are nowhere near the point that that question would even arise in their minds.

Mr. HORMATS. Two thoughts on that. One, I very much agree with the point that they are, at this point, facing liquidity problems and that to move toward a situation where they faced a general structural decline would be more the result of a real decline of the international economic system. But of their own will, I think few countries are going to let the situation deteriorate to that point.

Second, I get back to Senator Proxmire's question, can countries repay their debt. I think one has to look at it and differentiate. The answer I gave was yes—they can repay their debts. That is not to say that they will eliminate all debt. And I think that one has to make a verbal distinction between the two.

As Bill Miller pointed out, countries, rarely eliminate their overall debt. But the question is can they repay the debts that they have incurred—can they, in fact, make good on their debts. And I believe that if the question is put that way, not "can they eliminate debt entirely," then barring some enormous structural calamity, the answer is likely in most cases to be yes.

Senator MATHIAS. I think Secretary Miller's exposition of that was extremely helpful. Countries can repay debtors but not necessarily repay debt.

Mr. HORMATS. That is an important distinction. In fact, no country really, as in the case of the U.S. Government, will ever repay all debt. It certainly can repay individual debtors. And I think most of these countries will be able to do that.

Senator MATHIAS. The last point that I think the committee would find helpful is one that Mr. Hormats and Secretary Miller were both in agreement on, but not Mr. Ogden or at least he did not mention it. Mr. Ogden has been the most optimistic of our witnesses, and I am glad for that.

But you do say that the margin for error in resolving the world's debt problem is relatively small. Let us assume that we find that small area in which we get into problems either because of high interest rates or returning inflation or whatever the cause. Would you then consider the proposition that Secretary Miller and Mr. Hormats and Senator Bradley all made, that we have to have some method of dealing with wild fluctuations of exchange rates?

Mr. OGDEN. Mr. Chairman, I think the wild fluctuations of exchange rates are really a very different issue from the problem of the debt of these 8 to 10 middle-income countries. A related issue, yes, but different. But I do think that we ought to try to address these wide swings in exchange rates. As someone pointed out, exchange rates used to be based essentially on trade and inflation differentials. But those two explanations just do not really explain the dollar moving back and forth within a period of 2 to 3 weeks. It is a much more complex issue than that, and I think that the proposal for a summit to better coordinate monetary, fiscal, and trade policy might be helpful in that respect.

Senator MATHIAS. Mr. Hormats.

Mr. HORMATS. Just one thought on that. Technically they are different issues. But as all of our testimonies have pointed out, there is an interrelationship, and the problem today is that frequently if the exchange rates deviate too much from what people think is a reasonable relationship, then there will be pressures on the trading side to make that balance right. And that is what we see today.

And what happens is that countries and firms who believe that the dollar-yen relationship is way out of line and therefore is distorting trade will decide that they will not give the market a time to correct it and they will instead ask for corrections through restrictions in the trading system. And that, of course, has a feedback effect of the financial situation.

But, you know, as I put in my testimony, I think these interrelationships, as we have all indicated, are very important. And if we have learned one thing from this crisis—or two things—it is, (a) that the developing countries play a very important role in the world economy and, (b) that the financial trade and growth issues all have to be dealt with as part of an overall whole. And it seems to me if the Williamsburg Summit does anything, it can be to underline that fact and make policies based on that awareness of the interrelationship.

Senator MATHIAS. Mr. Miller, do you have anything to add?

Mr. MILLER. Just to express my appreciation, Mr. Chairman, for your leadership in holding these hearings. I think they are extremely important.

Mr. OGDEN. May I join in that, Mr. Chairman. I must say this is an extremely important subject, and your patience in holding these hearings is very much to be admired.

Senator MATHIAS. It has been fascinating to have this kind of an education. I feel a little like the classic definition of the university. Mark Hopkins on one end of a log and a student on the other.

I feel I have had the advantage of being able to learn a great deal about the whole economic system as a result of these hearings. And I am very much the gainer. I hope we can put that knowledge and that education to some use for the country.

But it is extremely helpful to have you here, and I think today's dialog has been particularly good. Thank you very much.

I might say that we are going to hold one additional session, at which time there will be a witness from the AFL-CIO to discuss this question. And then we will have Secretary Shultz and Secretary Regan and a meeting of the full committee sometime in the middle of the month.

The committee stands adjourned subject to the call of the Chair.

[Whereupon, at 12:45 p.m., the subcommittee adjourned, subject to call of the Chair.]

GLOBAL ECONOMIC OUTLOOK

TUESDAY, FEBRUARY 15, 1983

UNITED STATES SENATE,
COMMITTEE ON FOREIGN RELATIONS,
Washington, D.C.

The committee met, pursuant to notice, at 10:30 a.m., in room SD-419, Dirksen Senate Office Building, Hon. Charles H. Percy (chairman of the committee) presiding.

Present: Senators Percy, Lugar, Mathias, Boschwitz, Pressler, Pell, Biden, Sarbanes, and Dodd.

The CHAIRMAN. The committee apologizes to all of you. There was a Cabinet session called by the President so that the Secretary of State could report to the leadership of the Senate and members of the Cabinet. We were delayed getting over here.

Secretary Shultz, we very warmly welcome you not only back to the United States but for your first public appearance before this committee in 1983. We are particularly pleased that you will be focusing your attention on the range of international economic issues which affect the conduct of U.S. foreign policy today.

No one in this room need be reminded that you bring to these issues a wealth of experience and expertise absolutely unique for a Secretary of State, coming at a crucial time in American history when international economic affairs are of greatest concern to all countries throughout the world. It will be our good fortune to have the benefit of your thinking in this area.

Senator Mathias conducted a series of hearings in January and early February in the International Economic Policy Subcommittee on the stresses and strains in the international financial system. Today we continue the hearings at the full committee level. The subcommittee received testimony from 15 witnesses including three former Secretaries of the Treasury, the former Chairman of the Council of Economic Advisers and the former Comptroller of the Currency.

I wish to particularly commend Senator Mathias for the great leadership and creativity that he and his staff have offered in focusing attention on the critically important economic factors which so influence our Nation's security, and certainly, the timing of it now, as the President this week sends forward his recommendations on IMF.

In these hearings we do not have to start the work, then, of determining what the nature of the problem is, what the burden is going to be. If the crushing debt incurred by these nations all come together, will it lead to a world collapse of the economic system?

We now have 2 solid months of hearings anticipating this action and recommendation by the President and action by the IMF.

The subcommittee hearings, together with the testimony we will receive today from you, Mr. Secretary, and the testimony of Secretary of the Treasury, Don Regan, who comes before this committee next week, will form the basis for our consideration of authorizing legislation for an additional U.S. contribution to the International Monetary Fund.

We welcome your views, Secretary Shultz, on the need for additional resources for the IMF. In addition, this committee is charged with authorizing the expenditure of U.S. dollars for foreign military and economic assistance. We want to hear from you on how such assistance is in the national interest of the United States.

We have, in short, a full plate of issues before us. I can assure you that this committee will move with great dispatch in getting these issues forward so we stay on schedule. We have already scheduled a discussion with Howard Baker so we can move right along on them, and we look forward to hearing from you today.

Senator Pell?

Senator PELL. Thank you, Mr. Chairman, and welcome. Today's hearing before our committee on the state of the international economy is, I think, symbolic of the importance which international economic issues have come to play in the formulation of our policy.

It is particularly fitting that our Secretary of State, George Shultz, himself a distinguished economist, should appear here today to provide us with his assessment on the state of the world economy and his recommendation for coping with the stresses of the economic system brought on by the severe recession in the industrial West.

I am sure you are aware, Mr. Secretary, that a number of individuals have raised questions about the $8 billion-plus contribution to the International Monetary Fund at a time when 12 million Americans are jobless, and expenditures on domestic programs have been cut to the bone.

I think it is necessary for the administration to articulate a strong and credible case as to why it is in our interest to greatly increase the resources of the IMF and provide funds for foreign assistance programs in these difficult times.

When I was on the hustings these past weeks, this question came up more often than anything else: Why should we send all this money abroad when our people at home need employment, shelter, food, and fuel? I think it would help us, the American people, if you could give specific reasons why it is to the advantage of the United States for these expenditures to be made. Why is it a good investment for the taxpayer? Why is it a good idea that the aid request from the administration will go from $5 million to $6.3 billion; that the contribution to IMF will go from $16 billion to $24 billion.

I think these are tough questions, ones that I find are very difficult to answer to my constituents when they press me in my State of Rhode Island, and I hope that today you could give us some specific reasons as to why it is to the advantage of the taxpayers of the United States to move ahead with these expenditures.

Thank you, Mr. Chairman.

The CHAIRMAN. I wonder, Senator Mathias, having conducted these subcommittee hearings, whether you would care to make a comment.

Senator MATHIAS. Mr. Chairman, I would rather hear from the Secretary, but I would take the opportunity to thank the extraordinary roster of witnesses that we had come to this committee with very deep preparation, who brought us an enormous amount of information so that we have a record, as you say. I think it will withstand challenge on this subject.

It is impossible to summarize all those hours of testimony in one sentence, but the message they brought us very clearly is that we live in an interdependent world economy in which unemployment in the United States is very definitely tied to the lower levels of trade with the developing world. The availability of capital is tied to the whole question of the world debt and how we manage it. We are going to have to proceed with great prudence and with a great deal of determination to resolve these problems.

I think the answers to Senator Pell's questions lie in the kind of program that the President alluded to in his state of the Union message, so I am anxious to hear what Secretary Shultz has to say on the subject.

The CHAIRMAN. We will try to adjourn close to 12 o'clock. The Secretary has an appointment at 12:30, but because he dealt with agriculture and just met briefly for a few minutes as he came into the building with some agricultural leaders, if you have any opening comment you would like to make, Senator Boschwitz and Senator Dodd, we would be happy to hear from you.

Senator BOSCHWITZ. I am sorry I missed Senator Mathias' hearings. I understand they were among the better hearings that have been held in quite some time. And I share Senator Pell's concern.

I hope you will deal, Mr. Secretary, with the differences between the budget authority and the outlays that, as I understand it, are involved in contributions to the International Monetary Fund. From the way I understand it these contributions would not increase the deficit, though they would increase borrowing.

Are you going to cover that aspect of it?

Secretary SHULTZ. Yes, sir.

Senator BOSCHWITZ. Good. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much. Senator Dodd, do you have any comments?

Senator DODD. Not at this time.

The CHAIRMAN. Secretary Shultz, we would be happy to hear from you.

STATEMENT OF HON. GEORGE P. SHULTZ, SECRETARY OF STATE

Secretary SHULTZ. Mr. Chairman and distinguished members of this committee, I am very pleased to have a chance to respond to your invitation to testify on the international economic system and the ramifications of it for the United States. So my testimony responsive to your invitation and the questions is focused on this subject.

I would like to say at the outset, however, that you should not infer from that that I think this is the only subject of interest in foreign policy matters, and in particular, I would like to say that the general program of security assistance and economic assistance is of great importance to us in our foreign policy.

I am delighted to learn that you are going to push ahead rapidly on your markup in this area, and I know that Under Secretary Schneider is due to testify, I think, on Thursday. I simply want to lend my support to what he will be telling you.

Restoring prosperity and stability in the world economy is one of the fundamental goals of the President's foreign policy. Progress toward that goal reinforces our other fundamental objectives—safeguarding peace and security and expanding the benefits of democracy and freedom.

I am going to divide my remarks on the international economic system into three sections. First, a discussion of the U.S. stake in the international economy—where do we come in. Second, an examination of the antecedents of the current situation and the challenges that it presents; and finally, a description of some of the actions that the administration is taking and my thoughts about them, to re-invigorate the world economy.

This country began as a trading nation. The legend of the Yankee Trader has faded with time, but no matter how remote the image, there are still plenty of Yankee traders among us, and I think partly as a result, foreign trade is now more important than ever to the vitality of our country.

In 1981, the United States represented about 25 percent of the world gross national product. One out of five U.S. jobs depends in some way on trade, and 40 percent of our cropland is devoted to production for exports.

In the last decade, U.S. merchandise exports, as a percent of our GNP, have doubled from 4 percent to over 8 percent. Much of this increase is attributable to the growing interdependence of the world's market economies in the 1970's.

Non-OPEC—leave the oil out of it—non-OPEC developing nations, for example, accounted for roughly 20 percent of U.S. exports in 1970. The same nations now account for nearly 30 percent of U.S. exports, which happens to be more than either the European community or Japan.

On the other side of the trade ledger, the non-OPEC developing countries supply about 25 percent of the goods we import for use by our factories and consumers. Since the counterpart to interdependence is dependence, it is not surprising that the Third World supplies more than half the bauxite, tin, and cobalt used in American industry, and virtually all the natural rubber, coffee, coca, and hard fibers used by American consumers.

The North-South trade connection is important but it should not be overstated. We should remember that Japan is our second largest trading partner, and our neighbors, Canada and Mexico, are first and third, respectively. Moreover, in the aggregate, the European Community is our single largest trading partner. Indeed, in 1982, U.S. trade with the EC totaled $46 billion as compared with $32 billion with Canada.

On the financial side, the United States has traditionally been a large investor abroad, and conversely, has attracted a great deal of foreign investment. In the 1950's and 1960's, returns to investment were higher abroad than at home, and the United States was a heavy net foreign investor.

The counterpart to this foreign investment was a persistent surplus in our merchandise trade. By the 1970's, the demand for new capital abroad had decreased, as had the U.S. supply of savings. Thus, the United States ceased to be a net capital exporter and usually incurred a deficit in merchandise trade.

This history is described in greater and more informative detail in the "Economic Report of the President," so I will not develop it further here. There is a very interesting chapter in the "Economic Report on the United States and World Economy" that I think is very well worth reading. There are a number of points in there that they develop well.

The United States is also a significant factor in international financial institutions, as you all referred to. Our support of the World Bank and the International Development Association helps mobilize capital for vital projects in the developing world. In addition, we are a major factor in the International Monetary Fund. The IMF is an instrument of collective action and although we are not a borrower, we still benefit when it supplements global liquidity and provides members with temporary balance-of-payments financing.

In sum, whether looked at from the trade side or the financial side, the U.S. stake in the international economic system is significant—significant in terms of jobs, income, and opportunities. Specifically, we can infer from this brief overview that the United States has a clear stake in the promotion of trade, in the vitality of the international financial system, and in economic stability in developed and developing countries alike.

Beyond pure economics, however, we also have a stake that is more political in character. The demonstration of the strength and viability of market-oriented economies and the democratic form of government with which they are associated. We should seize this moment to prove the potential of the open market mentality that inspired the Yankee traders.

In so doing, however, our own system will be put on trial. Therefore, if we urge other countries to adopt market-oriented policies, we should be sure to adhere to those policies ourselves.

The world is now coming through a period of painful decompression from the severe inflationary surge of the 1970's. That period has left us with serious problems: High unemployment in the industrial countries, large public sector deficits that constrain recovery, and the heavy debt burden of some developing nations that now strains the international financial system. These problems had their origin in the decade of the seventies. An analysis of that period reveals that they may have a common solution—economic expansion in the 1980's.

The level of developing countries' total debt, which now stands at nearly $700 billion, increased more than sevenfold from 1972 to 1982. In the same 10-year period, debt to private lenders jumped from 40 to 60 percent of outstanding LDC debt. The conclusion drawn from these facts by those who wish to fix blame is that either the banks overlent during the 1970's or countries overborrowed.

The truth is that many bad judgments were made. But it is also true that after the oil price increases of 1973-74, lenders and borrowers acted on a set of assumptions; buoyant export growth and low interest rates, that though proven false, were thought reasonable at the time. The recycling of petrodollars from the OPEC nations to the nonoil LDCs was a highly profitable business for the banks. And since the loans were in inflation-depressed dollars, the LDCs assumed that today's loans would be repaid with cheaper dollars tomorrow. In this environment, indebtedness mounted.

It would be wrong, however, to characterize the legacy of the oil shock years as a debt problem. Rather, in its broadest aspect, it is an income-earning problem.

True, LDCs borrowed a lot in the 1970's, but our domestic corporations borrowed a lot, also. The difference is the corporations invest in productive capacity to generate income to repay their debts. Some LDCs, however, tended to invest in consumption rather than production, borrowing to finance internal income transfers. This strategy, although of questionable wisdom, was tolerable as long as LDC export earnings grew fast enough to service their debts.

That was, indeed, the case from 1975 to 1979 when LDC exports grew 22 percent annually, roughly keeping pace with the 25 percent annual growth of LDC debt.

In response to the second oil shock in 1978-79, however, the major industrialized nations adopted more restrictive monetary policies which slowed inflation, boosted interest rates and set in motion a retrenchment from the economic excesses of the 1970's.

High interest rates and a strong dollar increased LDC debt service costs. Simultaneously, LDC export earnings declined as the recession reduced the demand for the slashed prices of LDC commodities.

Indeed, nonoil commodity prices fell 28 percent between 1980 and 1982, increasing debt service ratios and eroding the terms of trade. As Tanzania's President, Julius Nyerere, has put it to buy a heavy truck in 1981, Tanzania had to produce 10 times as much tobacco or 4 times as much cotton, or 3 times as much coffee as it took to purchase the same truck just 5 years earlier.

The problem faced now by Tanzania and other high debt developing countries is not so much a debt problem as an income-earning problem: Rising debt service costs consume an ever-increasing proportion of declining export earnings. Many LDC's are now under pressure to increase exports and curb imports. This comes at a time when the industrialized countries face rising unemployment, declining real income and deteriorating trade balances. As a result, the international financial, trade and monetary systems are under serious strain.

I recognize that is kind of a shorthand summary of much of your hearings, Senator Mathias.

The only lasting solution to the income-earning problem of the LDCs, as well as the serious problems of the industrial countries, is sustained economic growth without renewed inflation. The key to stimulating that growth lies in the interdependence forged in the 1970's of the world's economies.

Today, for example, the economic linkage between the industrialized West and the developing world is tighter than ever. Indeed, it has been estimated that if OECD GNP were to grow by 4 percent in 1983 rather than the projected 1.8 percent, the nonoil developing countries would earn an additional $15 billion on exports to the West, a figure equal to 14 percent of their estimated 1983 debt service payments.

The industrialized countries in my opinion are now poised to lead an expansion of the world economy. In particular, the United States is on the road to recovery. It appears to me personally—this is just a personal opinion—that the growth projections in the President's fiscal year 1984 budget will be exceeded. Interest rates are down, inflation is down, inventories are depleted. Basically, a very expansionary set of policies are in place. In short, the United States and other industrialized nations that have reduced inflation are positioned to play a vital role in world economic expansion.

The recent drop in oil prices may also stimulate expansion. Of course, an oil price decline is not unambiguously good, for any sudden unanticipated change in the world economy causes disruptions. An oil price decline may, for example, harm individual countries, especially net oil exporting LDCs such as Mexico and Venezuela.

But assume for the sake of illustration, as distinct from prediction—I underline that—but I want an illustration, and I take a big enough case so we can really kind of get an idea of the orders of magnitude involved here: a decline, say, to $20 a barrel which is a 40-percent drop. It has been estimated that such a price decline would, in the aggregate, have the following catalytic impact over a 2-year period:

Real growth rates in industrial countries would increase 1 to 1½ percent, and developing country rates 2 to 2½ percent. Inflation in the United States and elsewhere would decline 1½ to 2½ percent; the 1983 oil-import bill for industrial countries would drop by $90 billion, and that for LDCs by $9 billion. The OECD current account balance would swing from a deficit of $18 billion to a surplus of $17 billion. Simultaneously, LDC exports would rise 3 percent, cutting their current account deficit by $18 billion. A less significant oil-price decline would have similar positive effects, roughly proportional to the reduction from current prices.

Now, I say this not as a prediction but just to point up that with all of the handwringing you sometimes hear of about the possibility of oil-price declines, there is a very positive side if that should happen. And this just gives some notion of the orders of magnitude involved in the direction and the effect.

Senator BOSCHWITZ. Are you going to make a prediction later on in your testimony?

Secretary SHULTZ. No, sir; I have one, but I am not talking.

The salutary effects of the world economic expansion will not come about automatically. The United States, together with other nations, must work to insure that the opportunities for growth are seized. In turn, this means that we must concentrate our efforts on four objectives. First, insuring sufficient liquidity in the international financial system; second, preserving open markets; third, improving the international monetary system; and, fourth, insuring political stability in the developing world.

In working toward each of these objectives, which I shall address in turn, cooperation will be essential. Cooperation between the public and private sectors, between the developed and developing worlds, between business and Government, and between the executive branch and the Congress.

The basic elements for successfully dealing with the liquidity problems of the high debt developing countries are known and in place. The so-called debt bomb can be defused through emergency, short-term bridge financing, leading to adjustment programs implemented in conjunction with the IMF and with the cooperation of commercial banks.

Private banks, however, are now reducing their rate of new lending to the developing world. Net new bank lending was flat between the first half of 1981 and the first half of 1982. Estimates for the second half of 1982 show a precipitous drop in new lending, which we have to say it is not surprising that that should happen under the circumstances.

Such an abrupt contraction in new lending obviously would imperil the recovery of the debtor countries. Moreover, reduced lending in the face of increased debt-service costs would also retard our own recovery by contracting LDC imports from the West. Indeed, as Rimmer de Vries recently testified, a Morgan Guaranty Trust Co. study estimates that if capital flows into the LDCs were cut by $25 billion, OECD growth would drop at least a half a percentage point. With OECD growth in 1983 expected to be only 1.8 percent, half of a percentage point represents a significant cut in growth.

The Morgan Guaranty study is hypothetical. But import cuts are already a reality. A dramatic case in point is Mexico whose 1982 imports from the United States dropped 36 percent from the 1981 level. Consequently, in the course of a single year, the U.S. balance on merchandise trade with Mexico swung from a $3.7 billion surplus to a $4.5 billion deficit.

The international economy is too vulnerable to this kind of contradiction to permit a continued decline in lending to the Third World. Private banks have a collective interest in extending sufficient new money to permit the developing countries to service their debts. Western governments, including our own, have a similar stake in seeing that the LDCs have sufficient capital to pay for imports of goods and services that will enhance LDC productivity and contribute to world economic expansion.

The United States, I believe, stands ready to do its part in this effort. Where appropriate, we will provide funds, as was the case with Mexico, through bridge financing, CCC credits, Eximbank loans or swap facilities.

This administration will also be seeking congressional support for the expansion of IMF resources, coming directly to Senator Pell's question. In just-concluded negotiations last Friday, member countries agreed upon a quota increase of 47.5 percent. The U.S. share of this increase will be approximately $5.8 billion. I might note that the quota increase is not a U.S. budget item—this, I think, is going to be responsive to your point, Senator Boschwitz—

for it represents an exchange of financial assets; cash in exchange for a drawing right on the IMF.

More importantly, our quota represents an investment in international financial well-being. The purpose of the IMF is not to pay off old debts, but to encourage sound policies. Indeed, indications are that a borrowing country's creditworthiness tends to improve with the successful implementation of an IMF program, and private lending then generally increases rather than declines. A quota increase is thus an inherent component of any program to encourage world economic growth.

Another component of such a program is the expansion of the general agreements to borrow. A GAB was initially established by 10 industrialized nations as a backup line of credit to be drawn upon solely by the 10 contributing countries.

However, late last month in Paris, the United States, together with the other nations of the group of 10, agreed to almost triple the GAB from $7 billion to $19 billion. Our share of this expansion is $2.6 billion. I think, incidentally, the number that is being quoted is the sum of the $5.8 and the $2.6 billion. That is where that $8.4 billion figure comes from.

Unlike the traditional GAB, access to this expanded fund will not be limited to the G–10 alone, but will be accessible to any country whose liquidity problems threaten the financial system as a whole.

Our share of the IMF quota increase and the GAB expansion totals $8.4 billion. This is the amount we will be asking Congress to approve before the end of 1983. And Secretary Regan, of course, is the pointman in presenting that to you, but I want to say here that I fully support what he is doing, and I think the combination of Don Regan's efforts and Paul Volcker's efforts with other finance ministers, and central bankers, and Jacques de La Roussiere, an outstanding international civil servant, has been very important here and effective.

Let me turn to the trading system. Even if the sustained bank lending and increased IMF resources prevent a sharp contraction in LDC liquidity, the success of our financial efforts will ultimately depend on adjustments in the trade accounts of developed and developing countries alike. Import cuts can provide only so much; export growth must lead the way in the recovery of the LDC's. Therefore, we must resist protectionist pressures and seek to preserve the system of open trade we helped to build.

The recession and high rates of unemployment in the West understandably have increased protectionist pressures. The 98th Congress will probably confront local content legislation, agricultural and other subsidies and a host of protectionist proposals directed at hard-hit sectors such as steel and autos.

These protectionist moves threaten to impede our own recovery and economic expansion generally. Quotas, tariffs, and other trade barriers raise costs to us and deny borrowing countries the hard-currency earnings needed to service their debts and buy our exports. Conversely, open trade speeds resources to their most productive uses and creates more jobs than it destroys.

That does not mean, however, that we should acquiesce in other nations' trade-distorting practices, expecially those imposed on sectors such as agriculture and services, in which we enjoy a comparative advantage.

This is what we were discussing just before coming here, Mr. Chairman.

Subsidized agricultural exports from the EC, for example, have enabled European farmers to expand their share of third country markets at the expense of U.S. farmers. In response, we recently sold subsidized wheat flour to Egypt.

Temporary, trade-distorting measures such as the wheat flour transaction can be justified on the ground that "when all the world is mad, 'tis folly to be sane." But we should remember these are insane things to be doing.

Temporary measures tend to become permanent; and retaliation has an inherent tendency to escalate. Constructive negotiations—in which we meet unreason with reason—present the only lasting solution to protectionist problems such as export subsidies.

We have a situation emerging where, for example, through this competitive subsidy program various countries in the world will be producing butter, and as the butter gets sold in the world market and winds up in the Soviet Union, through this insane system of subsidies butter will be produced and sold to the Soviet housewife at about one-quarter the price the American housewife pays for it.

Can anyone explain why that makes sense? I do not see it.

We will, therefore, work within the GATT to remove barriers to the export of U.S. services and agricultural products, In addition, we will work on a bilateral basis, as I did on my trip to Japan, to roll back trade barriers. Difficult but important negotiations with the EC on agricultural trade subsidies are now in process. Finally, we will seek concrete ways of implementing the open trade pledges made by the major industrialized countries at the Versailles Summit and the GATT Ministerial.

Turning to the monetary system, trade is encouraged by stability in exchange markets—something we have not had in recent years. The instability of relative currency values over the last decade is basically a reflection of turbulent economic conditions. But several developments have created recent problems for the trading position of U.S. producers.

Financial flows, for example, are having a powerful effect on exchange rate movements. This presents difficulties from the standpoint of trade. During 1982 financial flows into the United States led to the greatest appreciation of the dollar since the beginning of floating rates in 1973. The strong dollar increased the price of U.S. exports and decreased the cost competitiveness of U.S. industry. Consequently, the U.S. trade deficit in 1983 is expected to widen.

Moreover, if large outyear budget deficits are not reduced, they will consume U.S. national savings, which already accumulate at the lowest annual rate in the industrial world. A shortage of savings would drive up both real interest rates and the dollar, thereby further widening our trade deficit.

In other words, what is happening to us here is we suddenly find ourselves in a kind of Switzerland position where big financial flows are having an effect on the value of the dollar. The market is behaving just right. I mean it is reflecting what is happening. However, when you look at trade, that strong dollar is making our goods much less competitive in third markets, thereby presenting a real trade problem to us.

An additional problem we face in the international monetary system is the great volatility in exchange rates. For example, between May and November of 1982, the yen depreciated from about 230 yen to the dollar to 276, raising the price of U.S. exports in Japan and third country markets, and reducing the price of Japanese imports in the United States. By the end of the year, however, the yen had swung back to its previous level of 230.

This point was made very vividly to me by Lee Morgan, the head of Caterpillar Tractor. And the effect of the big swing was basically to knock Caterpillar out of a whole set of third-country markets. It is not because something was wrong with management or they did not know how to sell in third markets or whatever. It was the tremendous impact on them of the swing in exchange rates.

The solution to such excessive exchange rate volatility is not clear. What is clear, however, is that the problem warrants close study by the major currency countries.

Finally, even if we succeed in increasing LDC liquidity, preserving relatively open trade and decreasing volatility in the exchange markets, adjustment for many developing countries still will be difficult—in some cases, testing what the social fabric will bear. Developing countries have had to accommodate the recession in the West and their own financial problems by cutting imports and curbing economic growth. Aggregate real LDC growth this year will be about 1 to 1.5 percent—the lowest since 1950. African countries have been especially hard hit because of their dependence on exports of primary commodities. Increasingly desperate, they are tempted by repressive strategies and radical panaceas.

LDC austerity can, if excessive, risk political instability that endangers U.S. strategic interests. In this hemisphere, economic difficulties threaten to increase illegal immigration into the United States. Economic troubles were a factor in the recent expulsion of hundreds of thousands of Ghanians from Nigeria. And economic difficulties in the Sudan could, for example, threaten the U.S. interest in Middle East stability.

In short, our own strategic interests dictate the following rule: While LDC adjustment is necessary, such adjustment must take place within the limits of the politically possible, and with sufficient financial support to maintain stability and spark renewed growth.

This analysis has, by necessity, been quite general. Yet I think its implications are straightforward. The problems currently burdening the international economy—recession, high unemployment, LDC debt—all have a common solution: economic expansion. If growth in the world economy resumes and real interest rates fall, the debt burden of even the most heavily indebted countries will become manageable.

The key to recovery from the debt problems, however, lies in increased exports from developing countries. That increase is in turn dependent on an expansion of our own economy and those of other industrialized countries. Economic expansion anywhere can help everywhere—but not necessarily.

For if we expand, while simultaneously erecting protectionist barriers, neither the LDC's nor the industrialized countries will benefit from that mutually reinforcing boost to recovery provided by open trade. In shutting out goods from the rest of the world, we will incur not only the usual costs of protection—higher prices to consumers and jobs lost in the export sector—but retard our own recovery and threaten the world economic system as well.

Our challenge, therefore, is to revitalize the international financial system; preserve and extend the benefits of open trade; improve the monetary system; and insure political stability in the developing world. This administration is working hard to achieve these four objectives, all of which contribute to world economic expansion. Our own economy will play a leading role in that expansion. As a result, we have an opportunity to demonstrate the continued viability of our market-oriented economy, and the democratic institutions it supports.

Thank you, Mr. Chairman.

The Chairman. Thank you very much, Secretary Shultz.

Because of the number of Senators here this morning and the time constraints we are working on, without objection we will go on a 7-minute rule.

Mr. Secretary, just before we came in here we met with farm leaders, and they put the question to you of the problem of the United States being a stable supplier and supported strongly actions taken by the administration in contract sanctity.

There was a position taken on those pipeline sanctions, which we appreciate, a position of leadership that you and the President took. Could you say something about long-term contracts with the People's Republic of China, and longer than a 1-year extension that has been already committed with the Soviet Union? Are we working toward a longer term agreement so we can destroy this image that we are not a reliable supplier?

Secretary Shultz. First I think it is very important for any trader to be viewed as reliable, so that when we say we will do something or I as a private businessman or farmer or whatever say I will do something and I sign up to that, that the person I am signing with can count on it. That is an essential ingredient in trade, so we have to cultivate that idea, and sometimes, unfortunately, things happen that make it necessary to break a contract. But I think that we should view that as something that happens as a last resort and under the most extreme circumstances. Otherwise, we lost our position in the trading world.

As far as agricultural sales in China and the Soviet Union are concerned, of course, those represent both large potential markets for our farmers. Both from the standpoint of our farmers' role in our own markets and from the standpoint of the attitude of people to whom we are selling, reliability is an important ingredient.

Other things reasonably equal, long-term agreements are desirable because they tend to give information about what is happening to the marketplace and provide a level of assurance to both suppliers and consumers about what can happen. So as a general proposition I think they are desirable.

In order to move forward on them I think we need an atmosphere that is congenial to the expectations implied by long-term agreements; so it is an important part of our diplomacy to try to upgrade that atmosphere. Obviously it takes two to do that, and it is a great big broad problem, and I hope we can make headway with it. But it is a difficult situation to predict.

The CHAIRMAN. Will consideration be given to not only increasing the limits at the bottom—6 million tons now—but also increasing the maximums?

Secretary SHULTZ. All of these things would be part of any negotiation, and just where one would come out would remain to be seen. Right now there seems to be an atmosphere of surpluses in the agricultural field. It isn't always that way, as we can all remember, and nature tends to have a way of imposing some variability. And so you have to be ready for both types of situations.

The CHAIRMAN. In your statement you touch briefly on a problem that the strong dollar creates for the competitiveness of U.S. exports. We hear not only from farmers but manufacturers on this. From your view or our view the overvalued dollar is a critical impediment to increased exports.

From your own perspective as an ex-budget director should we first be doing more to reduce the future budget deficits; what else could be done? Second, do you think with resepct to the yen that the yens value as against the dollar is entirely set by the free market, or there are things that Japan could do to bring the yen in closer parity to the dollar?

Secretary SHULTZ. Two different questions there, one having to do with the monetary system and the other the budget. Let me take the first and then the second.

I did not say that the dollar was overvalued or that the yen was undervalued. The market has made an evaluation. What is happening is that we have tended historically to think of the dollar or currencies as reflecting sort of trade flows and relative inflation rates, and then the values sort out to bring about some stability there.

A few countries have had a rather different problem, Switzerland being the outstanding one, because it has in a sense as much the characteristics of a bank as it does of a country. Financial flows have been very big there for a couple of reasons. Particularly in the last couple of years there have been very big financial flows into the United States, and they have tended to become very important in setting the value of the dollar.

The market has correctly reflected these flows, so in that sense you cannot say it is overvalued or undervalued or anything. The market has been reflecting these facts: That money has come to the interest rates here and, I believe, seeking a safe haven. The fact that money keeps coming even though interest rates are going down is a measure of that fact. But it poses problems for our merchandise trade, and that is something that we have to scratch our heads pretty hard about.

There is no evidence that the Japanese have been maneuvering the value of the yen; and that has been looked at very hard by the Treasury, and they see no evidence for that whatever. It is more along the lines of what I suggested.

I would point out also in the President's Economic Report there is a very interesting chart that shows the cross rates with the dollar of the yen, of the Deutsche mark, of some other currencies, but the yen and Deutsche mark are the two principal ones there. The track is rather parallel, so you have a broad influence here.

On the budget side, I think the outyear deficits are the thing to focus on. Personally, I think that the deficits in the current fiscal year and 1984, while it would be desirable to compress them somewhat, are nevertheless ones we can live with. It is the outyear deficits that are frightening to financial markets.

Just what they will turn out to be, of course, remains to be seen, and I do not have total confidence in our ability to project exactly what our economy will look like 5 years from now; but people have done the best they can, and we see that there is a substantial deficit. The President's contingent tax proposal I think is a good one and a way of addressing that, and of course, the spending side needs to be worked on continuously and hard.

The CHAIRMAN. Thank you, Mr. Secretary, and congratulations to you on a much-needed and I think an outstanding trip to the Far East.

Senator Pell.

Senator PELL. Thank you, Mr. Chairman.

In connection with the exclusive economic zone, under which you know, we would have the exclusive right to all living and mineral resources within a 200-mile area on a line from our shores, what are the plans of the administration? Do you plan to move ahead with a unilateral declaration on that, or would you be willing to wait until we have had a hearing on the matter?

Secretary SHULTZ. You catch me unprepared, Senator Pell. I have thought about the Law of the Sea Treaty a lot, and that is a point that I have not registered on. I know that we feel that the 200-mile limit that is established in the Law of the Sea Treaty is something that we would claim for ourselves and do claim for ourselves. Certainly a hearing is fine, but I am not sure what the juxtaposition of a formal declaration in a hearing is. I would have to get back to you on that.

Senator PELL. Let me submit that in writing, if I may, sir.

Secretary SHULTZ. Certainly.

Senator PELL. I thought your statement was excellent. I found that even though I am no economist myself, I understood it and its thrust. But I speak to you as a representative of an administration which is terrific in communication, headed up by a great communicator, and in this regard I want you to imagine yourself not having a group of friendly Senators here but having as I had a couple of weeks ago, 500 very angry individuals without enough fuel, cold, not enough food, some of them depending on soup kitchens, some of them looking for lodging.

Many people are very upset at the foreign aid program and its corollary, the IMF. When you add these figures up, they really are tremendous. How would you in very simple terms explain to people who have no college degrees, half of them no high school degrees, what the advantages to the American poor and unemployed and cold and hungry Americans are of the aid program?

Secretary SHULTZ. There is a lot of variety in the programs being spoken of. There is the support for the IMF and the General Arrangements to Borrow. There we essentially have asset trades in the interest of maintaining the health of the system and keeping it from breaking down.

Senator PELL. To these people the system has broken down.

Secretary SHULTZ. Well, it has broken down but not irreparably. The question is to keep things together so that as our economy expands, that can take place with as much flourish as possible; and people will be able to get their jobs back or get other jobs, so the process of job creation can proceed.

I think the evidence for the importance of the international trading system and financial system to that is overwhelming. The expansion of trade has been accompanying one of the greatest booms in history, not only for ourselves but for our trading partners. So everyone has benefited from that. Their standards of living have risen. That is the line along which I would try to make the explanation.

It is also true that if our trading partners suffer too badly—and the developing country examples I gave, such as Mexico, are dramatic, we see what that has done to us in many ways. So we have a stake in keeping other people healthy, just as we have a stake if we are a member of a community in keeping the whole community healthy, not just ourselves alone.

Senator PELL. When it comes to explaining to our people the question of jobs or the lack of jobs here and the difference in competitive ability that we face—automobiles, for example, where the Japanese are producing cars with fewer work people, where the salaries, when you check into it, the benefits of permanent lifetime employment and the side benefits are not that much different in wages from the scale that we have here—it is very hard to explain to them that we are losing our competitive edge. And I think it takes more than a theoretical explanation.

What I am really groping for here are for some specific arguments that can be used as to why the aid program and free trading, fair trading, is a good idea; because the protectionist sentiment, as you know, is building up very hot and heavy.

Secretary SHULTZ. I think you have to point, if you are a farmer, in the fact that 40 percent of our cropland is devoted to exports. Those exports have to go somewhere, and the people who till those lands are depended on that trade. Similarly, there are many industries that export heavily. There are other industries being affected by imports, to be sure, and some balance there is important and some sense of pace as imports increase is important.

In the textile case, for example, there has been a determination that imports should not increase faster than the rate at which the market itself grows, at least for now. And the result of that has been a negotiation to try to bring that into some kind of balance.

At the same time you mentioned the case of automobiles. There we have an industry where wages rose much faster during the 1970's than in manufacturing generally, which accounts for part of the problem. I think the auto union and industry has confronted this very courageously in the last couple of years. But at the same time I think we have to take note of the fact that the cars being produced off the U.S. assembly lines now are definitely superior to the ones of 3 or 4 years ago, in my opinion. They are more suited to the times, they are smaller, they are lighter. I think the quality has been improved greatly, so the U.S. consumer is getting something better.

One of the reasons is that our manufacturers saw that if they are going to stay around, they have to compete, and they have to make a product better; so we are getting benefits from that kind of competition. We have to keep remembering that. And thinking about the consumer, too.

Senator PELL. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Lugar.

Senator LUGAR. Thank you, Mr. Chairman.

Mr. Secretary, in the debate that is shaping up on the IMF, suggestions were made that restrictions ought to be placed on U.S. banks with regard to amount of foreign lending or other guidelines by our own banking system. It has also been suggested that there ought to be some rediscount window or facility created in which U.S. banks might discount some of the paper that they have abroad, get out of the international lending business, take a loss and write down uncollectible loans so that we are not jeopardized continuously by this overhang of $500 or $600 billion.

What comments do you have on either the guideline issue—that is, whether we ought to be having guidelines on our banks—and whether the banks should either simply mark down these loans or we should create a facility to handle some rediscount of its paper?

Secretary SHULTZ. Well, on the guidelines, probably that is a good idea if the enactment is not too specific. When you start new regulations, you generally wind up sorry 5 years later, because there are all sorts of unanticipated results, if you give too little opportunity for those who are going to administer them to adjust them to the circumstances.

Basically, however, I would have to say this is a subject on which I would defer to the Treasury. They have thought about it a lot more than I have had the opportunity to do.

As far as creating some sort of governmental discount window through which our private banks can unload their debt, I am very dubious about that. I think that it is desirable for our banks to be in the international lending business. It is a good business for them, and they should take their part in financing the international economy.

I think it is a problem that there is a retreat going on now. We need liquidity in the current situation. The answer to these debt problems, as I tried to develop in my testimony, is to get the system healthy and expanding; and while I do not want to be advocating price increases, certainly there are many primary commodities right now that are very depressed in their prices. So if we saw some comeback in those prices and we saw world expansion coming along, I think a lot of these debts would look different and could be handled. I would rather see them worked out that way.

Senator LUGAR. Mr. Secretary, in your testimony you stressed this thought: that as opposed to a debt repayment problem we ought to be thinking in terms of income earnings for many countries that are growing. But is this not primarily a political problem in the sense that even if IMF or other loans are made is not the problem of growth within those countries essentially the nature of their economic systems? In other words, what kind of encouragement could we give to private enterprise in those countries whose centralized economies have rather poorly used their assets and come up with horrendous debts. Poland is a good example of this: No amount of IMF lending or private lending would apparently turn this around at this point.

Could you address yourself to the political dimensions of what we might be able to do?

Secretary SHULTZ. One of the advantages of the IMF, I think, is that the IMF is able to develop conditions for loans with the Government better than we ourselves or any other single government can do—and certainly far better than private lenders can do. So the idea of so-called conditionality with IMF loans I think is an important idea to preserve and enhance.

Now, then, you have to come to the question of what are the conditions and how much sense do they make. Broadly speaking, I think the IMF has tried to develop conditions that will help the economy involved regain its momentum and its capacity to deal with its debt. However, the IMF just cannot dictate things to people, and different countries have their own ideas about what they want to do with their tax system. Many have prices of basic commodities that are controlled at a very low level—energy and food being two big examples—and it is difficult to let up on those prices.

So I do not think that a standard of perfection by our lights is something that we can see imposed everywhere; but I think we should like to see things moving in the right direction. And on the whole, I think the IMF is trying to do that.

Senator LUGAR. Let me just add a comment to that. Senator Pell certainly has had an experience similar to those of each one of us at home during the recess. I would say on behalf of my constituents in Indiana that we appreciate that 2 out of every 5 acres being planted in our State will be exported, and we hope that someone will have the money to pay for it.

Secretary SHULTZ. Well, that is what we are talking about here.

Senator LUGAR. One out of every eight manufacturing jobs presently is for export—goods and services, machinery, mechanisms, parts and so forth. Without export we are dead in the water.

On the employment side—and I think this is the point we were attempting to make—I would say simply that it is clear in my State that we will have to have export financing facilities available or we will have higher unemployment.

Secretary SHULTZ. I think export financing facilities is one point, and providing some funds to the IMF is another point; but basically what we are trying to do, it seems to me, or should be trying to do is different. We should be trying to help provide an expanding and healthy world economy so it is that fundamental expansion that is providing the market into which we are selling, as distinct from the particular stimulative devices that are talked about.

Senator LUGAR. Thank you very much.

The CHAIRMAN. Thank you very much.

Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

Mr. Secretary, I am a little concerned about a possible implication of your statement. You are not asserting, I hope, that no loans were made to countries now in difficulty at a time when careful and prudent analysis of their situation would have argued against making the loans.

I understand your point about the assumptions under which people were proceeding in the mid-1970's with respect to export growth and low-interest rates, which you outline in your statement, but are you suggesting that all of a sudden one morning we woke up to discover, to our great surprise, that we had a difficult problem which no one could have seen coming if he had taken a more careful look?

Secretary SHULTZ. No, sir. I think I say that many bad judgments were made.

Senator SARBANES. If that is the case, should not the request for an increase in the IMF quotas involve some process to assure that we will not again find ourselves in the situation we now face, otherwise, won't we be back for another increase in IMF quotas sometime in the future because in having gone down this path without some way to raise early warning flags?

Secretary SHULTZ. Well, of course, the market has provided a kind of censure to people, and there have been a lot of bad loans that people have had to record. Quota increases are now associated dramatically with this problem, but of course historically as the world economy expands and the need for world liquidity expands, you would expect there to be a larger IMF facility. So it isn't all simply related to this particular problem.

I do think the assumptions that turned out to be wrong were very widely held. It is true that some people were saying watch out, this is not going to go on this way and so on. And probably most of us could find some statement that we made somewhere that said that. So with hindsight and second-guessing, you can look much wiser than a lot of loan officers look right now.

That does not mean they should be taken off the hook. That is their job to make those judgments, and when they make bad ones, they have to pay for it.

Senator SARBANES. They invariably will be taken off the hook, will they not? The consequences that would normally flow from such judgments will not be allowed to happen when the debtor is a country and when the size of the debt is so large that if we followed the normal course, we would give a major shock to the international financial system.

Is that not simply a given?

Secretary SHULTZ. I think what we are saying is something like this: We have a choice. We can say that all you countries around the world, including our own, and banks, including our own, made some mistakes, so that you are going to have to live with those mistakes, and we are not going to do anything about it. Let the world system go down the drain. We would rather have it go down the drain and then pay for their mistakes than to try to help work the situation around so that we do not go down the drain.

Senator SARBANES. That is right. You are not advocating the first approach, I assume.

Secretary SHULTZ. I am advocating the exact opposite.

Senator **Sarbanes**. No one does advocate the first approach, because its consequences are too heavy to bear.

Secretary **Shultz**. Right.

Senator **Sarbanes**. In the course of trying to work this out, should we not set up procedures to help assure that we will not go down that path again?

For instance, what would be wrong with requiring that all private loans to governments be submitted to the IMF for review and comment—let us leave aside approval—so that we know what is happening and have some sense of how much in private lending is accumulating?

Secretary **Shultz**. Well, we have through bank regulation, in this country anyway an ability to know what the banking system is doing. We do not have a lack of that kind of information.

Senator **Sarbanes**. Other countries do not require that, and they make these loans. And in a great many instances, a good part of the private debt is owed not to American bank's but to foreign banks. But the international banking system is interrelated, as the whole financial system is, as you point out.

Secretary **Shultz**. It is interrelated, and at the same time I, personally, would not be ready to put into the hands of a kind of world central bank a regulatory authority over the flow of loans. I do not think the evidence is strong at all, granted that some bad judgments have been made, that on the whole, government judgments are better than the sum total of private judgments. I think it is the other way around.

Senator **Sarbanes**. When you use the word "regulatory authority," how do you define that?

Secretary **Shultz**. I suppose you are saying that you would—and I am just taking your suggestion, which I thought it to be—any time a private loan is made outside the country of the lending institution, that loan should be registered or somehow run through the IMF for comment. Presumably you mean that that should be true for U.S. private loans and also for those originating in other countries.

Now, that sets the IMF up as a central functioning, virtually a regulatory agency. It is not at all clear that other countries would accept that. I do not know what our country's attitude toward that would be. But I think it is something that I would personally be rather reluctant about.

Senator **Sarbanes**. What assurance can we give the people we represent, as we are now confronted with the question of expanding the IMF quotas, that some safeguards have been put into place to assure that this situation will not reoccur, that we will not be back again seeking another increase in the IMF quotas because once again a number of loans were made that everyone now agrees should not have been made?

Secretary **Shultz**. We can hope there is some learning from experience. We can see that some people were caused to lose some money. I think myself that the private banks have been drawing back as a matter of fact from international lending faster than is desirable and that if it goes on too far and too fast will be damaging to the general interests of the private banks.

But at any rate, it suggests that there has been caution imposed. Senator Lugar has raised the question of some guidelines insofar as our own banks are concerned. And no doubt, that will be considered and should be. But I do not see that anyone can give an assurance that governments will never engage in the excesses that bring about and encourage the sorts of problems that we have had.

If you come right down to it, where did this originate? Government is responsible for the inflation. The Government of the United States put on wage and price controls. I was there kicking and screaming, but I was there. It was a catastrophe.

We kept the price of oil down. It was only when President Reagan came in that finally the controls were taken off. And we see how healthy that result is. So governments made mistakes all through this process that have helped create an environment where lots of other people made mistakes, too. I do not know that we can lay down a guarantee that Government will never make a mistake again.

Senator SARBANES. Mr. Chairman, my time is up. I just want to make an observation. I think the administration ought to be giving some constructive thought to coupling their request for an increase in the IMF quotas with some procedures to provide assurances that we will not go down this path again.

In saying that, I am not using the debater's device juxtaposing extremes, either that we should assure that governments will never make a mistake in the future as they have in the past, or that the alternative is to suggest that the system should just be allowed to collapse, et cetera, et cetera.

But it does seem to me that there is a range where we can work toward some constructive proposals to link this request for an increase in the IMF quotas to some process—whether it is a review process, and how it involves other countries, are questions to be worked out—that will provide assurances in the future that if we start down the same path, there will be some early-warning flags raised. Otherwise, we are just leaving it open for a repeat of the current performance.

The CHAIRMAN. Thank you.

Senator Mathias.

Senator MATHIAS. Mr. Chairman, I would like to pursue the theme that has been raised by Senator Sarbanes and Senator Lugar of the private sector banks' involvement in this process, because I think that it is very close to the heart of the whole remedy.

Senator Sarbanes says that the banks will escape the consequences of their poor judgment. During the course of the hearings that issue was dealt with at some length, and one of the witnesses said, we are not bailing out the banks, we are bailing them in. And this, of course, is the fact.

The President's request and the IMF increase of quotas by 47.5 percent is not going to do this job. If that is it, in my judgment, we have a failure on our hands. Another necessary ingredient is that the commercial banks stay in and live with the consequences of their prior judgments. And more than that, that the banks increase their lending on an annual rate of something like 7 percent until we get through this very shaky period. And it is going to require this joint action of the private sector and the public sector to get us through a rocky time in the world's financial condition.

Secretary **Shultz**. I agree with that entirely, Senator. I think you are absolutely right.

Senator **Mathias**. The question, of course, Mr. Secretary, is this. The commercial banks in the United States consider themselves in some cases overextended on foreign loans. Maybe in the judgment of objective observers, they are overextended. But they have to stay in. Are we asking too much of the banks, not too little but too much? Many of the regional banks I think would like to get out.

Secretary **Shultz**. I think it is very much in the interest of the private banking system as a whole to stay in and to provide new money, as you suggested. When there is difficulty, of course, an individual bank may want to get out, and particularly regional banks, which many feel they really do not understand what is going on very well and have become part of the syndicate.

Senator **Mathias**. And that is a big group. There are 1,500 regional banks.

Secretary **Shultz**. And they do not have the capacity to get out and work around the world. They have to rely on the larger banks that take the lead in the syndicate. So when there is trouble, they like to retreat. But it is very hard to manage this, because if one is let out, then everybody wants out and all of a sudden you have a kind of a run on the bank, in effect.

So I think that it is important to hold these groups together, and it is not asking too much. It is asking the private banking system to measure up to its responsibilities and its interests. And so far, particularly the big banks have been doing a pretty good job of holding people together.

Senator **Mathias**. I concur with that. And the regional banks seem to be willing to stay and seem to be willing to go forward for the time being. I agree with you that it is in their self-interest as well as their general interest to do. But you take a rather optimistic view of where we are going economically, and I hope you are right.

Secretary **Shultz**. I do not want to be a pollyanna about it. There are plenty of problems, and I have tried to identify them. But I do not think that we can just sit and wring our hands about the problems. We have to say, well, there they are, now what can we do about them?

Senator **Mathias**. You have to go forward.

Secretary **Shultz**. There are things to do about it, and no doubt, in the whole picture the most important thing to do about it is to have the conditions created in the United States whereby our own economy will expand. That is the key. We are 25 percent of the world economy.

Senator **Mathias**. The question was asked, will you have to come back again for another quota increase? And I would think that if the projections of growth are accurate, if they are realized, that we may get through on this quota increase for the foreseeable future. But you would not suggest, would you, that if the world economy does continue to stagnate, that there may not have to be another review of IMF capacities?

Secretary **Shultz**. I would not say that, nor would I say that if things work out well, there would never be another review of IMF capacity, because that capacity has to reflect the general scope and size of the world economy. So if 10 years from now or 5 years from now things have worked out well, we will have a much bigger enterprise, in effect, to try to manage.

Senator **Mathias**. I think clearly the consensus agrees with you that we have to have growth, No. 1. That is the essential ingredient. And if we have it, we have a fair chance of avoiding further immediate difficulties.

One thing that you mention in your statement about which there is not yet a consensus is the question of exchange rate stability. Clearly, the poor relationship between the dollar and the yen, as you have described it very vividly, is the root of many of our trade problems with Japan. It has swung wildly in the recent past. When our inflation rate should have been pushing it one way, it went the other way.

Should we have some kind of international arrangement that at least controls the far end of the swing, perhaps not the day-to-day fluctuation, but the wild swinging of currency rates, something like the European "snake," which I do not pretend to fully understand but which seemed to work.

Secretary **Shultz**. Some very exotic terminology. Back in the early 1970's we had the tunnel and then we had the snake in the tunnel and a lot of jargon like that. It was great.

Senator **Mathias**. But do we need something of that kind?

Secretary **Shultz**. Well, this is a question that is raised a lot, and I would not lay down an answer. I think that it is important.

Senator **Mathias**. You have a lot of company in not being willing to lay down an answer.

Secretary **Shultz**. I think it is important that the system be flexible. The par value system of the 1960's basically broke down because there was no way for the dollar to get itself adjusted to what was happening. Other currencies all could play off against the dollar, but the dollar was frozen. The floating system now opens that up. The extremes of volatility I think have reflected the fact that we have had a tremendous amount of turbulence connected in considerable part to the big swings in oil prices. And if the situation becomes less turbulent, there will be more stability.

So in that sense, the exchange market is more a thermometer registering the heat than it is a producer of the heat itself. Whether or not now there should be some effort to give the system some additional constraints is a question that I am sure is being considered. And I would not want to leave it at that. I would think the way to approach it is to think in terms of just a few currencies rather than the whole world currency system.

The currencies that are in the SDR basket are the main currencies. And if the relationship among them or even among, say, the dollar, the yen, the Deutsche mark, the French franc and the pound were a little more stable, then everything else kind of relates itself to that, and it may be that something can be done to bring that about.

There has been a study of the effects of intervention that is about completed. And I do not know what the results of that are.

Secretary Regan will be testifying, and he will be in a position to tell you about those results. I would be surprised if the study shows that intervention can really affect basic values. It does not figure that it is able to do that.

The CHAIRMAN. Thank you, Senator Mathias.

Senator Biden.

Senator BIDEN. Thank you very much.

Mr. Secretary, what we need is a mongoose in that tunnel. The fact that has been mentioned time and again in the discussion that has gone on here about imprudent bankers making decisions raises the questions whether the Government makes decisions that are equally as imprudent or maybe even more imprudent and who is the cause. One of the problems that folks like us on the committee have in doing what I think has to be done—and that is, acceding to the request you are making—is a purely political one. Not in the Democratic-Republican sense, but in terms of explaining it to our constituencies and explaining it to some of our colleagues on the floor of the U.S. Senate.

And what concerns people—I think I know the answer to this, but I would like to hear you say it—what concerns people is that when Government makes a mistake, they know they are sort of a stockholder and they lose. But everybody loses in the country: The taxpayer, the stockholder in a sense.

But when a private enterprise makes a mistake, particularly banks who are not really well liked anyway—in my State, at least, and I do not come from a State that is unaccustomed to dealing with banks and corporate entities—they feel like they are being "had" and that only a relatively few people, relatively wealthy people are "being bailed out."

My first question is: Is it practical from an economic standpoint for any of the banks to get out?

Secretary SHULTZ. Well, if it is just one bank, it is practical. But if one person gets out, everybody else wants to get out, and if everybody gets out, then you bring about just the situation you are seeking to avoid.

Senator BIDEN. The reason I ask that is I do not think it is a very fruitful discussion for us in the Senate to be discussing, whether or not the banks want to, are doing us a service by staying in or are being done a service by staying in.

The fact of the matter is, we are all in this mess together, and the banks just purely from their own economic standpoint know that one could get out but that might cause a run so they know there is not much they could do if the Government does not do anything, on the one hand. On the other hand, we sit here and we know that we have to do something, at least I think the majority of us do, that we have to do something to prevent what is a potential disaster.

Now, my question is: Is there anything, would there be any way—I think I know the answer to this, but I just want to ask it—is there any way that the U.S. Congress could so construct conditions upon this additional money that would result in helping avoid the catastrophe we are worried about; that is, doing its job, bringing about some stability without any profit accruing to the banks? Could you say, to be bizarre about it, we will come up with the additional money that we think we need but there will only be principal paid back by these countries to the banks; the banks have to swallow their interest; they are not going to make any money?

I know that sounds ridiculous, but those are the kinds of questions I get asked by my constituents. As I said, I think I know the answer, but I would like to hear you respond to that question. If you were at a town meeting in Dagberg, Del., what is the answer to that question? If it goes beyond 60 seconds, they do not listen.

Secretary **Shultz**. I think it is unwise to approach it as a punitive matter. The way to approach it is to try to make the system healthy, and then everybody can prosper.

Senator **Biden**. Well, I will be the devil's advocate. Let's say I do not want those banks to prosper. I do not care if they are going to prosper. They are going to take my tax dollars. Is there any way we can prevent it from being a disaster but make them pay the price for having made the bad judgment they made?

Secretary **Shultz**. Well, I think that when people approach our financial system with minds made up that says no one should prosper in our financial system, you have a fundamental problem there.

Senator **Biden**. No one should prosper for their mistakes.

Secretary **Shultz**. Well, they are not prospering from their mistakes. They are suffering from their mistakes. The question is how drastically and how catastrophic do you want to make it?

Senator **Biden**. That is good enough answer. I will try that one next time. [Laughter.]

Secretary **Shultz**. I think with a little thought, I could do better.

Senator **Biden**. I am going to ask you to maybe write a speech for me to justify what I am about to do.

Let me say on a more serious note, all of your proposals relating to the amount of money we are talking about here are premised upon certain assumptions with regard to economic growth not only in this country but around the world, that we are going to be coming out of this recession, which is not only U.S. recession but a worldwide recession.

Have you calculated how those numbers change if, in fact, we do not have an economic growth for fiscal year 1984 that the President is predicting in terms of U.S. economy, which is, as you pointed out, 25 percent of the whole ball game, and the world economy generally, or just take the big three, four, or five nations?

Secretary **Shultz**. I have not tried to run through the econometric models of what happens to this, that, or the other. But obviously, if our economy fails to grow and the other industrial economies fail to grow, that is very bad news, and that tends to make borrowings and debts look worse. And you can say that that shows that the judgment was bad to make the loan in the first place, but I do not know that that is necessarily the case.

Senator **Biden**. I would not argue that, just for the record.

Secretary **Shultz**. It is just like saying if things go bad and somebody has to foreclose on the debt for a farm, say, that the judgment was bad to have made the loan in the first place. That is not necessarily the case.

Senator **Biden**. The reason I asked the question is along the same lines I thought Senator Mathias was pursuing, and that is that I would think we should be realistic with the folks and with our colleagues and with the country and be saying, look, we are not making this infusion conditioned on the notion that we will never be back at it again. I think we should be more honest about it and say, this is what is needed now, we may need more.

And my time is up. One last question, like everybody always does in this committee when their time is up. We are not going to do it this time, apparently. OK, I will not ask it. [Laughter.]

I just do not think you should be increasing aid to Turkey by a quarter of a billion dollars this time. But I will get back to that.

The CHAIRMAN. Thank you very much.

Senator Boschwitz.

Senator BOSCHWITZ. That was an afterthought, Senator Biden.

We find, Mr. Secretary, that Senator Biden, Senator Pell, and myself, who are more imminently facing our constituents in elections, have a greater interest in not intellectualizing the banking system, though I must say I have learned something about the banks from both my colleagues from Maryland.

However, as Senator Lugar pointed out, our farmers certainly understand that large portion of what they produce goes into foreign trade. But they do not have an explanation, or we do not have an explanation, when our country gets involved in the bilateral type of situation with Brazil, as we recently did, when they subsidized so heavily their agricultural exports in competition with our farmers.

I am careful in the legislation that I introduce. I am not particularly wild-eyed, but I am one of the Senators who has introduced some of the legislation you warn us about in your statement, that the 98th Congress you said will probably confront legislation in the agricultural and other subsidies, a host of protectionist proposals.

I have indeed introduced such legislation because I do not feel that some of our trading partners in the agricultural field or in other fields, particularly Japan, are going to lower some of their subsidies or some of their tariff barriers unless we confront them rather blatantly and straightforwardly with the understanding that we will act similarly.

They have not fired the first shot of a trade war; they fired several salvos already. And we find ourselves being excluded from world markets. So I was very approving with respect to the sale of flour to Egypt. In that one sale we sold more wheat flour than we had sold in the entire preceding year of the entire year before that to the entire world.

But my question is, Mr. Secretary: Our negotiations with some of these countries have not been very productive, and they just keep on doing the same old things and referring the cases to the GATT. It has taken almost a decade so far in trying to get the resolution to some of these cases. Would you respond to the necessity of such legislation that several of us have introduced for the purpose of ridding the world trading place of some of the subsidies that are imposed upon it by our so-called allies or some of the barriers that they impose against our trade?

Secretary SHULTZ. I think it is very important to keep things from closing up further and at the same time do everything we can do to get them opened up more. We do have to shake people and say, wake up, world, if this continues and we really get into a competitive protectionist subsidy game, it is bad for everybody.

And if the United States really gets into it, we can have a devastating impact because we have a very deep pocket, when you get right down to it. And if we start a big agricultural subsidy war and that becomes the common way in which agricultural products are marketed in the world, no doubt, we will be able to do our share. But the nut of it all will not be good; we will in effect, be, giving product away.

So I would say that the wheat flour sale that I referred to in my testimony and that you mentioned was on the one hand designed, of course, to sell some of our product but also to say to people that we are serious about this problem and we think that the negotiations to resolve these problems better be taken very seriously by everybody or this whole thing can slip out of control.

Senator BOSCHWITZ. Well, perhaps that is the answer then to legislation—that our Government exerts its seriousness in that manner. Perhaps this also includes that butter sale you spoke of since we sell the butter at about the world market price. Since it has sold at about half of the price that was taken to remove it by the CCC, I am sure that the butter would not be sold at one-quarter of what the American consumer would pay for it in Russia—unless they do subsidize it.

But the last time we sold a Communist nation some butter, they objected because it is salted, and that is not particularly desirable.

Secretary SHULTZ. Not only did they want to cut price but they want to have it to their specifications.

Senator BOSCHWITZ. Well, there is not much you can do with salted butter in the world market unless you melt it down.

I see you also mentioned services. I am aware that that is becoming a very significant element in our exports. And also I am aware that there were never really any considerations given to service exports, and as a result, rules or barriers have not previously arisen. But those barriers are now arising. Service exports I think have a very promising future for this country, and I would hope our Government would take a very firm viewpoint with respect to the erection of barriers in that regard as well as with respect to agriculture.

Secretary SHULTZ. We have been taking the lead in trying to get attention to that in the GATT, and there now is at least, a study under way of that general area. Of course, services is a word that covers a gigantic array of things that are very unlike each other, and in the end as this process proceeds I am sure there will have to be a breakdown of that word and much finer categories introduced.

Senator BOSCHWITZ. Mr. Secretary, I know that you are very short on time, and it is 12:15 and there are still a couple of Senators who yet are to question you.

I agree with your statement about the positive effects of a decline in oil prices to $20 a barrel—you give that as a for-instance, I think that if open market principles were to play a part, oil certainly would be at that price or lower. And I believe that it will reach those prices, and I do not have much sympathy with the oil-exporting countries or those banks which have made loans to those countries. I hope you are right. I hope your example is correct.

I hope also the increase in economic activity that will result will make the loans of many of the banks now in jeopardy much better while it makes others much worse. I feel sorry for the banks that feel sorry for the oil-exporting countries. It is kind of like feeling sorry for the guy who kills his mother and father and throws himself on the court for mercy as an orphan.

Secretary SHULTZ. I had not really thought of the analogy that way.

Senator BOSCHWITZ. Well, I have. And I think that the decline in oil prices will do a great deal in treating our general economic recovery.

The CHAIRMAN. Thank you, Senator Boschwitz.

Senator Dodd.

Senator DODD. Thank you very much, Mr. Chairman.

Mr. Secretary, let me quickly state that I found your statement to be extremely worthwhile, and I agree with an awful lot that you have said here. Senator Glenn and I took about 10 or 12 days in January and traveled to Central and South America. We spent most of our time in Mexico and Brazil, principally on the question of international indebtedness. As you know, there is approximately $190 billion between those two countries alone, of the some $700 billion in worldwide debt obligations.

Briefly, let me tell you, and I am sure Senator Glenn would agree, that our assessment was that both Mexico and Brazil are going to make it. Brazil is probably in a little better position than Mexico.

Mexico has some serious problems, and the question of reduced international oil prices, while it is very encouraging to the overwhelming majority of nations in terms of their ability to meet their obligations, given the existence of a 2,000-mile border with Mexico and its dependency on oil sales for a good part of its economic recovery program, this price reduction could have catastrophic implications in terms of immigration and the stress and strain it would place on our frontier.

But let me bring up one other point here. We have concentrated pretty much this morning on the question of the IMF and the economic recovery program. I would like to turn to the foreign assistance request that the administration has made for fiscal year 1984 along with its supplemental for 1983.

My concern is this. I could not agree more with your statements about economic stability in the world and how important that is, not just in terms of economic recovery but also because the political implications associated with economic stability are so profound. It is something I think you would agree with wholeheartedly.

And yet, as I look at the request that has come before us, totaling some $13.5 billion, an increase of almost $2 billion over the previous year, the bulk of the program as $9.2 billion of the the $13.5 billion is in security and military assistance.

Now, I am not one who suggests that we ought to eliminate military assistance programs. And I understand that a good part of it goes to Israel and to Egypt. But when you see a 20.8-percent increase in military aid and only a 3.3-percent increase in development assistance for fiscal year 1984 is seems to me that our actions in terms of providing funds for economic recovery are clearly unsatisfactory.

I would also point out to you that historically the coalition in this body and in Congress generally that have supported foreign assistance has been formed of those who generally agree with the development assistance programs and have had some concerns about military assistance. Increasing dramatically as we are the amount of military assistance jeopardizes that coalition in Congress at a time when we may need it most.

I wonder if you might address that general observation and the concern that I have both with respect to the increase in military assistance worldwide; and also the concern that I have that the coalition in Congress may evaporate if, in fact, this trend continues. You have heard Senator Pell, Senator Boschwitz, Senator Biden, and others as well talking about constituent concerns regarding foreign aid generally. And when we see the increase in military assistance, I think that concern becomes even more alarming.

Secretary SHULTZ. Our request is for $14.5 billion all together, and represents an increase of 4.6 percent in current dollars from our request least year. In other words, in real dollars, it is about a wash. Now, the way it was broken down between security assistance and economic assistance is not precisely the way it looks in those categories. As we tabulated in the security assistance program of $9.2 billion, $6.2 billion is strictly military aid, and the balance, $3 billion, is essentially economic growth-oriented money.

Senator DODD. Economic support funds, balance-of-payments funds.

Secretary SHULTZ. In the economic assistance program, you have a total of $5.3 billion, so if you add economic support funds and the economic assistance together and compare it with the military, you have a little over half in economic support and less than half, 43 percent of the total, is military aid.

Senator DODD. Isn't it a fact historically that the economic support funds and funds that they are given in grant assistance, are generally used by nations to buy military equipment, which is hardly what many of these countries need to be doing. If they hope to achieve some economic stability, they ought to be investing those dollars in economic development programs at home.

Secretary SHULTZ. I think in the countries involved, being able to get themselves some stability is an essential ingredient for economic development, and if they are being attacked and ravaged by a guerrilla movement that is being supplied by arms from the outside, and they do not have the capacity to contest that, and thereby to try to create stability within their own country, they are not going to get anywhere in economic development.

You cannot expect there to be development in the context of a kind of military harassment.

Senator DODD. I am not suggesting to you that I am opposed to all military assistance. It is merely when we were talking about limited funds, growing domestic concern, the protectionist, isolationist mentality that is very strident in the country, when the major thrust of your remarks of this morning, ones which I agree with, emphasize economic stability and the danger of some economic collapse, then it seems to me at this very hour our limited dollars ought to be focused in the economic development area. If my figures are correct, they show a 20.8-percent increase in military aid, a 2.3-percent increase in Public Law 480, and 3.3-percent increase in development assistance. That is how it breaks down.

Now, it seems to me if these percentages are correct, our actions in terms of where those scare dollars are going seems to be contrary to the declared policy.

Secretary SHULTZ. Well, the figures represent our judgment and the President's judgment about the kind of help that is most needed for the stability and economic growth of the countries involved, and obviously there is a balance. As we have discussed, I do not have the numbers classified the same way you do, but when Mr. Schneider is here Thursday, he will have it classified every which way and can respond a little more directly to your questions.

But as a general proposition, we have sought to have the right balance between military and economic matters in the overall package, and I agree with you that having a healthy economy is the way to get stability in these countries. At the same time, I am sure you agree with me that it is hard to imagine that kind of economic growth if you not have some stability in the military conditions of the country.

Senator DODD. I was not speaking specifically of El Salvador as the thrust of my question.

Secretary SHULTZ. But you probably had it in mind.

Senator DODD. I have another question on that one, but I see my time is up. Mr. Chairman, I gather my time is up.

The CHAIRMAN. Thank you, Senator Dodd, very much.

Senator Pressler?

Senator PRESSLER. Thank you very much.

Many of the areas have been covered, but I would just reiterate what has been said so well here today regarding the two worlds of foreign policy. I just returned a few hours ago from my State of South Dakota, where I had 25 listening meetings or open door meetings, and almost every one was volunteered. Someone said, spend less on foreign aid. The big bankers are getting bailed out. The foreign policy establishment is working against us. I am sure you are well aware of that.

But the point is, we have to somehow have a marriage between the world of the Foreign Relations Committee and the Council on Foreign Relations and the conference in the State Department. We are coming to a head on this budgetary matter, and you have already answered that or responded to it, but is there any way that you can expand on your public statements to explain to the small business, the farmer, the wage earner that there is a great deal of feeling from some of the TV reports. I am sure you are well aware of it. In the 25 which were held over the last 10 days, it was voluntarily raised in every meeting that that is the feeling.

But in any event, I pass that on to you, and you have already commented. If you want to comment further, fine. If not, I will go on to some of the other questions that I have.

Secretary SHULTZ. I think it is a very good point. The President feels that these requests are appropriate and needed, but it is also up to us and to all of us here to convince people in our country that these programs are good for them. That is the ultimate test. What is good for the United States?

We are saying that we are in a boat with a lot of other people, and we will prosper or go down together, and these are things that we think will be helpful in that regard. I agree with you, we have to get out and sell this program, and I am going to try and do it.

Senator PRESSLER. In your recent trip to Japan—Japan is very reliant on the Persian Gulf oil. I have been concerned about burden sharing both in aid and defense. Does the concept of the Japanese helping to defend the Persian Gulf ever come up in any discussions you had with them?

Secretary SHULTZ. There has been a lot of discussion between ourselves and the Japanese about their own effort in defense, and the new prime minister, Mr. Nakasone, has taken a somewhat more forthcoming leadership stance on that subject. We have to remember that Japan by its constitution, which we had a lot to do with, has certain restrictions placed upon itself militarily.

Nevertheless, I think within that framework there are more things that they can do, and I see evidence myself that they are trying to do those things.

Senator PRESSLER. As I understand it, and this is not a question on the banks, but it is related to aid, the administration's request would reduce the forgiven military assistance program for Israel by $200 million from last year, from $750 million to $550 million. What are the reasons for this reduction?

Secretary SHULTZ. Well, again, we have tried to put forward a balanced program which looks at the needs of Israel and the needs of other countries around the world, and within a framework of what we think is doable, to divide that up accordingly. The overall share of these total funds that goes to Israel is very substantial. I do not have the proportion right in my head at this point, but at any rate, the numbers are, in the judgment of the President, the appropriate numbers.

Senator PRESSLER. The fiscal 1984 military aid request for El Salvador is more than three times the amount contained in the fiscal year 1983 continuing resolution, from $25 to $85 million, yet the economic assistance request has been reduced by $20 million from last year. Does this indicate that the administration is inclined toward a military solution to the problems of El Salvador?

Secretary SHULTZ. The solutions in El Salvador have to emerge from a country that has political stability and is able to attain economic growth. The military situation in El Salvador is such that our judgment is that they need the military boost that those number represent.

Senator PRESSLER. In that region, should we be prepared to take special measures to assist Mexico should oil prices drop further?

Secretary SHULTZ. Well, we have talked about the Mexican situation. I think we have to keep watching it. It is obvious that if oil prices drop further, the countries that are the big exporters will be the ones that will be affected adversely. I believe, as I said in my testimony, that the world economy generally will be affected very positively. We have to look at the Mexican situation, thinking of not only their interests, but our interests, and certainly I think we should look at it very sympathetically in trying to be helpful to Mexico.

Senator PRESSLER. Another country that is suffering somewhat from the decline in oil prices is the Saudis, and I am told that they are not fulfilling their previous financial pledges to Lebanon. How much they expected to contribute to the Lebanese construction efforts, and is this likely to be affected by the falling oil revenues?

Secretary SHULTZ. Well, obviously, they have had the greatest flow of oil revenues. On the other hand, they have very large total of assets that have piled up, so they are not broke by a long shot. They have the ability to provide additional funds. The question of how much for Lebanon comes forward from the Arab world, Saudi Arabia in particular, no doubt will depend on how successful we are in our efforts to get the foreign forces out of Lebanon and to have emerge an independent Lebanon able to govern itself and exert its sovereignty.

At this point, we are not there yet. So, people who are thinking about putting money in there are waiting to see what happens. The foreign forces are still there, as we all know, and there is considerable turmoil still in southern Lebanon.

Senator PRESSLER. Could the decline in oil prices have any effect on the Saudis' ability to carry out some of the pledges they have made during the sale of the AWACS?

Secretary SHULTZ. Well, the declining oil revenues have an impact on them, obviously, but the assets they hold are so large that they do not have any real problem with fulfilling any past pledge, I am sure.

Senator PRESSLER. I see I have a red light. I will submit additional questions for the record.

The CHAIRMAN. Thank you very much, Senator Pressler. We will make a phone call, if you would like, that you are a little tardy to your next appointment.

Mr. Secretary, before you leave, we have two very important nominations I would like your judgment on. Tomorrow morning at 11 o'clock we will be available for opening statements for Senators or comments on Director Adelman's nomination. We will have that vote at 11:45. We received notification, an announcement from the White House last year that our colleague, Ed Derwinski, would be nominated to be counsel to the State Department. We understand his papers will be arriving in the very near future, today some time. Would you care to comment on both of those nominations? Do both of those nominations have your full support?

Secretary SHULTZ. Absolutely. I have known both before they were nominated, and thought very well of them. In each case, I have had a fair amount of contact since they were nominated, and I feel that both will do a first class job; in the case of Mr. Adelman, that he will contribute significantly to the extremely important efforts in the field of arms reduction, and in the case of Ed Derwinski, an across the board kind of counselor role can be extremely helpful to us, and it would not hurt us at all in the State Department to have somebody there in addition to our excellent congressional relations staff, but somebody in our top group who is thoroughly familiar with the workings of the Congress and knows what listening to the grass roots is all about from his personal experience.

The **Chairman**. Well, I concur completely with you. I have known Ed Derwinski for decades. I think he can be of invaluable assistance to the Department at this particular time. And I will announce tomorrow the significant progress that Ambassador Adelman has made, including his last appearance, but also subsequently to that.

Thank you very much.

Secretary **Shultz**. Thank you, Mr. Chairman.

The **Chairman**. We will leave the record open for questions and for the Secretary to reply to them.

[Additional questions and answers follow:]

STATE DEPARTMENT'S RESPONSES TO ADDITIONAL QUESTIONS SUBMITTED BY SENATOR PRESSLER

Question 1. Secretary Shultz, what are your thoughts about the role of tourism in our economy and our foreign relations?

Answer. Clearly the tourism and travel industry occupies a prominent position in our economy. In 1982 it became the second largest retail industry in America in terms of gross sales and employment. Travel in the United States now accounts for more than $200 billion in domestic and foreign visitor spending, about 6 percent of our gross national product. It generates substantial employment, accounting for 18 percent of all new jobs in 1981. The industry employs directly 4.6 million Americans at every level of skill and an additional 2.3 million workers indirectly, generating over $40 billion in wages and salaries annually.

Tourism can play an important role in enhancing our foreign relations. Increased and less inhibited international travel of people from all nations for the purpose of cultural exchange, recreation and trade leads to understanding, friendship and ultimately to greater prospects for world peace. Tourism and travel to the United States is a valuable method of fostering appreciation of the values of democracy, freedom and human dignity.

Question 2. Would it be possible to designate at least one officer in each of our foreign embassies to work for an increase in travel and tourism trade to the United States? Some of the specific responsibilities of these officers would include the promotion of travel to the United States, informing foreigners about all that the United States has to offer, and facilitating and expediting foreigners' U.S. travel plans?

Answer. In accordance with the significant economic and foreign relations impact of tourism and travel to the United States, our ambassadors and their staffs are and will remain involved in tourism promotion and facilitation.

Scarce resources preclude assignment of individual officers at our posts abroad as tourism attachés to devote full time to the tourism promotion effort. Commercial, economic and consular officers now are jointly responsible for this function in addition to their other duties.

In the 66 largest markets for American goods and services, officers of the Foreign Commercial Service (FCS) of the Department of Commerce have principal responsibility for tourism promotion with support as required from consular and other mission sections. State Department economic/commercial officers have the lead in promoting increased travel to the United States in the remaining 73 countries. We will be pleased to explore with the Commerce Department the feasibility of designating a specific officer at each embassy or consulate as principal tourism promotion officer along with his or her other responsibilities.

In six key countries in which the U.S. Travel and Tourism Administration operates field offices, staffed by travel promotion officers with wide regional responsibilities, our missions provide administrative support, while commercial, consular, economic and information officers work closely with their USTTA colleagues to coordinate overall program activities.

Question 3. If such designation was made, could we also implement a training program to help these officers in the performance of their duty?

Answer. Whether or not specific officers are designated, it would be desirable for the U.S. Travel and Tourism Administration to develop a training and operational manual for the guidance of all officers involved in tourism promotion and facilitation. We will also consider including suitable training material developed in appropriate Foreign Service Institute courses.

Question 4. Finally, Secretary Shultz, as someone who has great experience in the international field, do you have any further suggestions or comments on increasing foreign travel and tourism trade in the United States?

Answer. In addition to expanding our promotional campaign in support of increased tourism and travel to the United States, we should strengthen our efforts to eliminate barriers which currently inhibit free and easy movement of all peoples—tourist and business travelers—to the United States and around the world.

The State Department has initiated visa waiver legislation which for the first time has been supported by all relevant departments of the Executive Branch. It was part of the Omnibus Immigration Bill passed by the Senate but not by the House in the 97th Congress. Enactment in the current session is essential if new procedures are to be in place in 1984 for the summer Olympics in Los Angeles and the Louisiana World Exposition in New Orleans.

The United States chairs the Working Group of the Organization for Economic Cooperation and Development's Tourism Committee, which has assembled and will define major barriers to international tourism with the intent to lead to their eventual elimination.

Also, we should continue support of the World Tourism Organization where the USTR is currently developing, in close conjunction with State and Commerce, an analysis of issues affecting world tourism. We intend to work for the removal of obstacles inhibiting an integrated tourism and travel industry.

STATE DEPARTMENT'S RESPONSES TO ADDITIONAL QUESTIONS SUBMITTED BY SENATOR PELL

Question 1. I understand that the President is currently considering whether or not to issue a proclamation establishing an Exclusive Economic Zone (EEZ) declaring all living and non-living resources within 200 miles of our shores to be within our exclusive jurisdiction. I believe that such a proclamation, if issued precipitously, may have major adverse foreign policy implications, and I cannot understand why the OES Bureau at State has been in such a hurry to push this through. Is there any particular urgency in your view for issuing such a proclamation?

Answer. After nearly 6 months of careful consideration, the Cabinet has unanimously recommended to the President that he issue a Proclamation declaring a 200-mile Exclusive Economic Zone.

We have consulted widely with other governments on this matter and have no reason to believe that our action will lead to significant adverse reactions abroad. I note that already 56 States of varying political persuasions have declared Exclusive Economic Zones.

I believe that this action by the President now will resolve any doubts at this critical time that the United States intends to act in accordance with those provisions in the Law of the Sea Treaty which reflect existing customary international law and will firmly establish U.S. leadership in this important area governing oceans usage. Further our actions will serve as a guide for other nations which desire to establish Exclusive Economic Zones.

Question 2. Could you assure us that any action on the EEZ be delayed until such time as Congress has held hearings on this matter?

Answer. The Department has and will continue to consult key Members of Congress and their staffs on the proposed U.S. EEZ. The President will be informed of the results of these Congressional consultations prior to this decision on whether or not to proclaim an EEZ.

STATE DEPARTMENT'S RESPONSES TO ADDITIONAL QUESTIONS SUBMITTED FOR THE RECORD

SPECIALITY METALS RESTRICTION

Question. 1. What is the Administration's position on the restriction, passed by Congress last year, on the purchase of foreign specialty metals by the Defense Department?

Answer. We are unalterably opposed to it. The restriction is inconsistent with our international obligations under the GATT Code on Government Procurement, as well as our commitments under a large number of the coproduction and offset agreements we have within the NATO alliance and with Switzerland, Australia, and Israel. The restriction is contrary to our continuing efforts to liberalize further the world trading system. It will invite imitation and retaliation by other countries which will be costly to the U.S. economy and the global economy. In addition, it will work against further NATO standardization and interoperability. Given that the balance of defense trade continues to be heavily in our favor, it is a particularly inappropriate measure.

Question. 2. How seriously do you take the threat of a European boycott of U.S. arms purchases?

Answer. I think that what the Europeans are saying is that practically all arms sales involve some kind of offset purchase by ther selling country. The current Specialty Metals legislation would severely restrict our ability to identify suitable offset purchases and thus reduce the competitive position of the U.S. in the European arms market.

Billions of dollars of potential sales in the future are threatened by this legislation as well as the proportional share in those sales of the U.S. specialty metals industry. For example, in 1980 our allies delivered approximately $400 million in defense equipment to either DOD or its contractors with an estimated foreign specialty metals content of only $4-$8 million. In contrast, U.S. defense equipment sold abroad contains only U.S. origin specialty metals. The total value of all U.S. arms sales to our allies in 1980 was approximately $2.2 billion.

Question. 3. In January, the Defense Department announced that it would submit an FY 1983 defense supplemental which, among other things, would include new language broadening the Secretary's specialty metal waiver authority. Does the Administration still intend to submit a defense supplemental? Will that supplemental be sent up even if the MX decision continues to be put off?

Answer. The Administration remains committed to seeking an FY 1983 defense supplemental including a provision on specialty metals. We do not expect that an MX decision would continue to be put off, but we do not intend to defer indefinitely our submission of a supplemental on specialty metals and other NATO-related programs. I cannot give you the exact timing.

[Whereupon, at 12:37 p.m., the committee adjourned, subject to call of the Chair.]

GLOBAL ECONOMIC OUTLOOK

WEDNESDAY, FEBRUARY 23, 1983

United States Senate,
Committee on Foreign Relations,
Washington, D.C.

The committee met, pursuant to notice, at 10:10 a.m., in room SD-419, Dirksen Senate Office Building, Hon. Charles H. Percy (chairman) presiding.

Present: Senators Percy, Lugar, Mathias, Kassebaum, Boschwitz, and Murkowski.

The Chairman. Secretary Regan, we welcome you before the Foreign Relations Committee this morning to discuss administration proposals for the IMF quota increase and for several multilateral bank replenishments.

This is the sixth hearing held by the Foreign Relations Committee and its International Economic Policy Subcommittee on international debt problems and their implications for the U.S. economy.

Last week, the committee took very useful testimony on this subject from Secretary of State Shultz. Previously, the International Economic Policy Subcommittee held four sessions with distinguished public witnesses.

We are all grateful to Senator Mathias, chairman of the International Economic Policy Subcommittee, for the leadership he has shown on this issue.

During these hearings, the committee has explored the reasons behind the fivefold increase in external debt of the developing countries during the past 10 years. Much of this debt was contracted in order to recycle petrodollars at a time of high inflation and low real interest rates. Repayment of this massive debt is complicated by additional oil price increases, high interest rates, worldwide recession, lower commodity prices, and shrinking world trade.

Mexico, Brazil and other major borrowers have in recent months been unable to service their debts. In order to maintain stability in international financial markets, the United States has recently reached agreement with other IMF countries to increase IMF quotas by 74.5 percent. In addition the United States has agreed with the so-called Group of Ten industrialized countries to expand both the size and scope of the IMF General Agreement to Borrow.

As a result, the administration will seek new budget authority of $8.4 billion for these two programs. Because this authority would result in a net exchange of assets, however, no new budget outlays will be required.

Mr. Secretary, the case for additional U.S. support for the IMF has been strengthened in recent days as it becomes clear that oil prices will decline. Reduced oil prices should strengthen the world economy and ease the immediate debt of many debtor nations in the developing world. Reduced oil prices will, however, threaten the economies of several debt-ridden oil-producing countries like Mexico and Venezuela.

The United States cannot afford to stand by idly and watch their economies fail, the implications for U.S. banks, U.S. exports, and U.S. foreign policy are too grave.

Mr. Secretary, it will not be easy to enact legislation this year authorizing $8.4 billion for what at first and has been unfairly, I believe, and inaccurately characterized in some of the media and some comments that have been made by colleagues of mine in the Congress as a combination of foreign aid and domestic bank bailout.

Yet, I know that you believe that the consequences of failing to enact this legislation will be severe.

This morning, the committee provides you an opportunity to explain the need for these programs—not only to us but also to the unemployed worker in Chicago, Providence, and Baltimore.

Finally, Mr. Secretary, the committee will seek your views on several ideas that have been raised concerning the IMF legislation.

First, should the request be presented as a fiscal year 1983 supplemental request?

Second, can the $8.4 billion request be stretched out over several years, or is the need so urgent that the entire authorization is required immediately?

Third, should the legislation be amended to add banking reform provisions?

Mr. Secretary, we again warmly welcome you to present your testimony on this critical topic.

Senator Mathias, again I want to commend you for the outstanding job you have done as subcommittee chairman in conducting hearings of the subcommittee on this extraordinarily complex but pressing problem. I would be happy to have any comments that you would like to make.

Senator MATHIAS. Mr. Chairman, you are very generous, as always. But I think what the Secretary of the Treasury is about to tell us will be more important than anything that I could add at the moment. I may have a question or two for him at the end of his statement.

The CHAIRMAN. Fine, thank you.

Mr. Secretary, if you would care to proceed.

STATEMENT OF HON. DONALD T. REGAN, SECRETARY, DEPARTMENT OF THE TREASURY

Secretary REGAN. Mr. Chairman, members of the committee, it is a pleasure to appear before you today to explain and support the administration's proposals for legislation to increase the resources for the International Monetary Fund. At the request of the committee, I will also discuss our proposals for multilateral development banks.

The written testimony I have submitted develops our proposals and their rationale in detail. In my remarks today I will go over some of the key points relating to the central role of the IMF that it must play in resolving the current international debt problem.

Since around the middle of 1982, we have been confronted with a serious international financial situation. The international debts of Argentina, Brazil, Mexico, and a growing list of other borrowers which have been growing much too rapidly for a number of years, have become very difficult for them to manage. Commercial banks have been cutting back sharply on new lending to those countries, compounding their liquidity problems.

As a consequence, the international financing and economic system is experiencing strains that are without precedent in the postwar era and which threaten to derail world economic recovery.

Chart A in my prepared statement illustrates the build-up of total LDC debt, and of commercial bank lending to the less developed nations.

The second chart—chart B—illustrates the sharp cutback in new commerical bank lending to these less developed countries in 1982. It makes the point that I just stated in my testimony. You can see the sharp rise from 1977 on and now the cutback in 1982 which is still going on in 1983.

The question is one of the speed and degree of adjustment. While the developing countries must adjust their economics to reduce the pace of external borrowing and maintain their capacity to service debt, there is a limit, in both economic and political terms, to the speed with which major adjustments can be made. Effective and orderly adjustment takes time and attempts to push it too rapidly can be destabilizing.

THE IMPORTANCE TO THE UNITED STATES OF AN ORDERLY RESOLUTION

There are a number of reasons why the United States should be concerned.

First, a further abrupt and largescale contraction of LDC imports could do major direct damage to the U.S. economy because about one-third of any cutback in imports by these less developed countries has to come directly out of American exports and American export-related jobs.

Foreign trade has become increasingly important to the U.S. economy. This next chart illustrates the very rapid expansion of U.S. exports during the 1970's. Trade was the fastest growing part of the world economy in the last decade; and in the latter part of the decade, U.S. exports grew more than twice as fast as total world exports. That is not usually recognized by most people, how fast we have grown since the middle 1970's in our export volume, using 1970 as a base.

As a result of this growth—as shown in the next chart—U.S. exports in 1980 accounted for 19 percent of total U.S. production of goods, compared to only 9 percent 10 years earlier. You can see that in this pie chart, 1970, and 1980, how our exports have grown.

U.S. agricultural exports, which is shown on the next chart, rose from $17 billion in 1970 to $42 billion in 1980, and our surplus on agricultural trade rose from $1.6 billion to $24.3 billion over the same period, which is illustrated in this chart here. You can see how we have grown from 1970 to 1980 and the importance of agriculture to our surplus.

Services have also become an enormous source of strength for the U.S. external position and the U.S. economy. The U.S. trade balance in services—which is illustrated in the next chart—rose from $3 billion in 1970 to $34 billion in 1980, and to an estimated $38 billion in 1982. This has probably been the fastest-growing part of our trade balance, services.

By 1980, U.S. export-related jobs totaled some 5.1 million. As indicated in chart G, the next chart, this represented an increase of over 75 percent in export-related jobs during the decade of the 1970's; and as of 1980, each $1 billion of U.S. exports was estimated to result in 24,000 jobs. So, you can see the importance that we place on exports.

Now, my next chart shows that nearly 30 percent of U.S. exports go to the non-OPEC less developed countries, representing a market of nearly $63 billion for United States goods in 1980. That is a terrific market when you look at it. Out of the total of $221 billion, non-OPEC LDC's, 29 percent.

Now, in the 1980 chart that part is shown in—what would you call that, magenta? Or at least a bright red.

Senator MATHIAS. I did not know you were such an artist. [Laughter.]

Secretary REGAN. Well, at least we have to recognize that we are not color blind. [Laughter.]

In that $221 billion, you would have to say—what would you call that, by the way, Senator, sort of a mustard? [Laughter.]

We would also say that that represents Canada, Great Britain, France, other nations of that nature, our major trading partners. But nevertheless, the non-OPEC LDC's represent a very important segment of that market.

Senator MATHIAS. When you get to Williamsburg, you will find a lot of that mustard color.

Secretary REGAN. It is almost a Williamsburg yellow.

Senator MATHIAS. Yes.

Secretary REGAN. On the banking side, there are also impacts of concern to all Americans. A squeeze on bank earnings and capital positions from troubled foreign loans would impair banks' ability to finance world trade. If the situation were handled badly enough and LDC borrowers were faced with another drastic cutback in available financing this year, they would be driven to consider measures which would result in widespread banking losses. Such losses could lead to a major reduction in the banks' ability to lend to domestic customers and significant upward pressure on U.S. interest rates.

RESOLVING THE INTERNATIONAL FINANCIAL PROBLEM

Our strategy for dealing with this threat has five elements:

First, and in the long run most important, must be effective adjustment in borrowing countries.

The second essential element is the continued availability of temporary balance-of-payments financing from the IMF.

The third is "bridge" financing by governments and central banks in lending countries, in exceptional cases of systemwide danger.

The fourth element in resolving debt problems is continued commercial bank lending to developing countries that are pursuing sound adjustment programs.

And the final part of our strategy is to restore sustainable economic growth, while avoiding protectionism which threatens both our own longrun growth prospects and the balance-of-payments adjustment efforts of the borrowing countries.

THE ROLE AND THE RESOURCES OF THE IMF

There are several reasons why the IMF has a central role in dealing with the current financing situation. IMF lending provides an extra margin of time and money which borrowers can use to bring their external positions back into reasonable balance in an orderly manner. The conditionality attached to IMF lending is designed to assure that such adjustment does take place. In addition, a borrower's agreement with the IMF on an economic program is usually viewed as a "seal of approval" of the borrower's policies and serves as a catalyst for additional private and official financing.

It now appears likely that the IMF's ability to commit resources to future adjustment programs will be exhausted by late 1983 or early 1984. If it is to continue playing its central role in resolving debt problems, its resources will have to be expanded before then.

At the beginning of the current discussions of IMF resources in 1981, many IMF members favored a doubling or a tripling of quotas. Ultimately, the IMF membership agreed to our alternative proposals:

First, a much smaller quota increase, which would be adequate under normal circumstances. The agreed increase in IMF quotas is 47 percent, an increase from 61 billion to 90 billion SDR's or, in current dollar terms, from $67 billion to $99 billion.

Second, establishment of a contingency borrowing arrangement that would be available to the IMF on a standby basis for use in situations threatening the stability of the system as a whole. The IMF's general arrangements to borrow would be modified for this purpose, and increased by about 10.5 billion SDR's to a new total of SDR 17 billion. Overall, the proposed increase in the U.S. commitments to the IMF under these agreements totals the equivalent of $8.5 billion at current exchange rates. Of that total, approximately $5.8 billion would be for the quota increase, $2.7 billion for the general arrangement to borrow.

Basically, the IMF is designed to further our economic interests, but in so doing it also benefits U.S. political and security interests. While the IMF is essentially a nonpolitical institution, it serves U.S. political interests well by containing economic programs which could otherwise spread throughout the international community; acting as a stabilizer in countries facing the social and economic dislocations which can accompany adjustment; and supporting open, market-oriented economic systems consistent with Western political values.

CONCERNS ABOUT THE INCREASE IN IMF RESOURCES

The general outline of our proposals has been known to Members of Congress for some time. Many have expressed reservations or questions about these proposals, and I would like to discuss some of the main concerns now.

First, is the IMF "foreign aid?"

Many perceive money appropriated to IMF use to be just another form of foreign aid and question why we should be providing U.S. funds to foreign governments. Well, the IMF is not a development institution, it is a monetary institution. It provides balance-of-payments financings only on a temporary basis, after obtaining agreement to policy conditions.

IMF conditionality has been controversial over the years, with some observers worrying that conditionality is too weak and others believing that conditionality is too tight. The facts are that the IMF steers a middle course—requiring that adjustment measures be taken but making it possible to adjust at an orderly rate. Most often, IMF programs make possible a higher economic growth rate and a higher level of imports than would otherwise be the case—in the short run by providing financing which would not otherwise be available, and in the longer run by promoting sound economic policies and expanded export capacity. The current situation in Mexico is a good example.

Mexico is our third largest trading partner, after Canada and Japan. And, as recently as 1981, it was a partner with whom we had a substantial trade surplus. The situation changed dramatically in 1982 as Mexico began experiencing severe debt and liquidity problems. Our $4 billion trade surplus with Mexico in 1981 was transformed into a trade deficit of nearly $4 billion in 1982. This $8 billion deterioration—which is illustrated in my final chart here—was our worst swing in trade performance with any country in the world, and it was due almost entirely to the financing problem.

You can see what has happened in the red line on the bottom where trade balance that we have had during this entire decade has now gone into a deficit.

We believe that this situation will start to turn around, and we can begin to resume more normal exports to Mexico when its economy is put on a more sustainable path. If this happens, it will be due in large part to the fact that, late in December, an IMF program for Mexico went into effect.

Another important distinction between IMF financing to the foreign aid is that all IMF members provide financing to the IMF under their quota subscriptions and all—industrial and developing alike—have the right to draw on the IMF. The United States has drawn on the IMF on 24 occasions—the most recent one being in November of 1978—and our cumulative drawings, amounting to the equivalent of $6.5 billion, are the second largest of any IMF member.

Now, another question usually raised is, Why spend money on the IMF?

Another major concern with the increase in IMF resources is that in this period of budgetary stringency, many believe we would be better advised to spend the money at home. There is also some feeling that if we can get the United States economy moving forward again, the international financial problem will take care of itself.

We will do what is necessary domestically to strengthen our economy. But we will leave a major threat to domestic recovery unaddressed if we do not act to resolve the international financing situation. An improving U.S. economy is going to help other nations, both through our lower interest rates and through an expanding U.S. market for their exports. But they also have an immediate, short run financing crunch to get through and, if we do not handle that right, there are substantial downside risks for our recovery.

Is the IMF just a bank bailout?

Finally, I know many believe that an increase in the IMF resources will amount to bank bailout at the expense of the American taxpayer. I would like to correct that impression.

First, the steps that are being taken to deal with the financial problem, including the increase in IMF resources, require continued bank involvement. Far from allowing them to cut and run, orderly adjustment requires that banks increase lending to troubled borrowers that are prepared to adopt serious economic programs.

Another point I would like to make is that the whole debt and liquidity problem cannot fairly be said to be the fault of the commercial banks. Certainly, part of it relates to decisions by banks. But part also relates to the way the world economic environment has changed. I think we can agree that governments have had a great deal more to do with shaping that environment than banks.

This is not to say that there are not lessons to be learned in the banking area. Both the banking regulatory agencies—the Fed, the Office of the Comptroller of the Currency, and the FDIC—and the Treasury will be reviewing ways of improving both the banks' procedures for screening foreign loans, and our supervisory practices in this area.

And now, Mr. Chairman, I would like to close with some remarks about our proposals for U.S. participation in the multilateral development banks. The MDB's are very different from the IMF. They lend primarily to finance portions of specific investment projects, at longer term—20 years or more—and only to developing countries.

We have considered it important that we be able to deliver on internationally negotiated funding arrangements for these MDB's. To that end, the administration has consulted closely with the Congress, both before and during the MDB funding negotiations.

When these have been completed, we will be proposing legislation to authorize appropriations totaling $960 million for the concessional lending programs of the Inter-American Fund for Special Operations and the Asian and African Development Funds, stretched out over several years in each case. This total represents a 24.5-percent reduction from the previous replenishments for these programs. Other donors will be providing $4 billion.

Agreements are also nearing completion for the replenishment of the capital resources of the Inter-American and the Asian Development Banks. The U.S. subscriptions to these two programs will be about $6.5 billion over fiscal years 1984 through 1988.

And now, Mr. Chairman, in conclusion I would like to state that the IMF plays a crucial role in the solution to current debt and liquidity problems, and in providing the environment for world recovery. It is absolutely essential that the proposed increase in IMF resources become effective by the end of this year, to enable the IMF to meet these responsibilities. Prompt U.S. approval is important not only because the financing is needed, but also because it would be a sign of confidence to other governments and to the public, and would help lay to rest concerns about the risks to global recovery.

But most importantly, timely approval of these proposals is essential to our own economic interests—to the prospects for American business and American jobs. The legislation to give effect to these proposals will be submitted to you in a very few days. I urge that you give it prompt and favorable consideration.

Thank you, Mr. Chairman.

[Secretary Regan's prepared statement follows:]

Prepared Statement of Hon. Donald T. Regan

IMF Resources, World Financial Stability, and U.S. Interests

Mr. Chairman and members of the Committee:

It is a pleasure to appear before you today to explain and support the Administration's proposals for legislation to increase the resources of the International Monetary Fund. As you have requested, I will also discuss our proposals for the multilateral development banks.

After extensive consultations and negotiations among IMF members, agreement was completed earlier this month on complementary measures to increase IMF resources: an increase in quotas, the IMF's basic source of financing; and an expansion of the IMF's General Arrangements to Borrow (GAB), for lending to the IMF on a contingency basis, if needed to deal with threats to the international monetary system. These must now be confirmed by member governments, involving Congressional authorization and appropriation in our case, in order to become effective. As background to the legislative proposals which we plan to submit formally to the Congress later this week, I would like to outline the problems facing the international financial system, the importance to the United States of an orderly resolution of those problems, and the key role the IMF must play in solving them.

The International Financial Problem

Since about the middle of last year, the international monetary system has been confronted with serious financial problems. Last fall the debt and liquidity problems of Argentina, Brazil, Mexico, and a growing list of other borrowers became front-page news -- and correctly so, since management of these problems is critical to our economic interests. The debts of many key countries became too large for them to continue to manage under present policies and world economic circumstances; lenders began to retrench sharply; and the borrowers have since been finding it difficult if not impossible to scrape together the money to meet upcoming debt payments and to pay for essential imports. As a result, the international financial and economic system is experiencing strains that are without precedent in the postwar era and which threaten to derail world economic recovery.

There is a natural tendency under such circumstances for financial contraction and protectionism -- reactions that were the very seeds of the depression of the 1930s. It was in response to those tendencies that the International Monetary Fund was created in the aftermath of World War II, largely at the initiative of the United States, to provide a cooperative mechanism and a financial backstop to prevent a recurrence of that slide into depression. If the IMF is to be able to continue in that rôle, it must have adequate resources.

The current problem did not arise overnight, but rather stems from the economic environment and policies pursued over the last two decades. Inflationary pressures began mounting during the 1960's, and were aggravated by the commodity boom of the early 1970's and the two oil shocks that followed. For most industrialized countries, the oil shocks led to a surge of imported inflation, worsening the already growing inflationary pressures; to large transfers of real income and wealth to oil exporting countries; and to deterioration of current account balances. For the oil-importing less developed countries -- the LDCs -- this same process was further compounded by their loss of export earnings when the commodity boom ended.

Rather than allowing their economies to adjust to the oil shocks, most governments tried to maintain real incomes through stimulative economic policies, and to protect jobs in uncompetitive industries through controls and subsidies. Inflationary policies did bring a short-run boost to real growth at times, but in the longer run they led to higher inflation, declining investment and productivity, and worsening prospects for real growth and employment.

Similarly, while these policies delayed economic adjustment somewhat, they could not put it off forever. In the meanwhile, the size of the adjustment needed was getting larger. Important regions remained dependent on industries whose competitive position was declining; inflation rates and budget deficits soared; and -- most pertinent to today's financial problems -- many oil importing countries experienced persistent, large current account deficits and unprecedented external borrowing requirements. Some oil-exporting countries also borrowed heavily abroad, in effect relying on increasing future oil revenues to finance ambitious development plans.

In the inflationary environment of the 1970's, it was fairly easy for most nations to borrow abroad, even in such large amounts, and their debts accumulated rapidly. Most of the increased foreign debt reflected borrowing from commercial banks in industrial countries. By mid-1982, the total foreign debt of non-OPEC developing countries was something over $500 billion -- more than five times the level of 1973. Of that total, roughly $270 billion was owed to commercial banks in the industrial countries, and more than half of that was owed by only three Latin American countries -- Argentina, Brazil, and Mexico. New net lending to non-OPEC LDCs by banks in the industrial countries grew at a rising pace -- about $37 billion in 1979, $43 billion in 1980, and $47 billion in 1981 -- with most of the increase continuing to go to Latin America. (See Charts A and B.)

That there has been inadequate adjustment and excessive borrowing has become painfully clear in the current economic environment -- one of stagnating world trade, disinflation, declining commodity prices, and interest rates which are still high by historical standards. Over the past two years, there has been a strong shift to anti-inflationary policies in most industrial countries, and this shift has had a major impact on market attitudes. Market participants are beginning to recognize that our governments intend to keep inflation under control in the future and are adjusting their behavior accordingly.

In most important respects, the impact of this change has been positive. Falling inflation expectations have led to major declines in interest rates. There has been a significant drop in the cost of imported oil. On the financial side, there is a shift toward greater scrutiny of foreign lending which may be positive for the longer run, even though there are short-term strains. Lenders are re-evaluating loan portfolios established under quite different expectations about future inflation. Levels of debt that were once expected to decline in real terms because of continued inflation -- and therefore to remain easy for borrowers to manage out of growing export revenues -- are now seen to be high in real terms and not so manageable in a disinflationary world. As a result, banks have become more cautious in their lending -- not just to LDCs but to domestic borrowers as well.

There is certainly nothing wrong with greater exercise of prudence and caution on the part of commercial banks -- far from it. Since banks have to live with the consequences of their decisions, sound lending judgment is crucial. In addition, greater scrutiny by lenders puts pressure on borrowers to improve their capacity to repay, and creates an additional incentive for borrowing countries to undertake needed adjustment measures.

But a serious short-run problem has arisen as a result of the size of the debt of several key countries, the turn in the world economic environment, inadequacy of adjustment policies, and the speed with which countries' access to external financing has been cut back. Last year, net new bank lending to non-OPEC LDCs dropped by roughly half, to something in the range of $20 to $25 billion for the year as a whole (Chart B), and came to a virtual standstill for a time at mid-year. This forced LDCs to try to cut back their trade and current account deficits sharply to match the reduced amount of available external financing.

The only fast way for these countries to reduce their deficits significantly in the face of an abrupt cutback in financing is to cut imports drastically, either by sharply depressing their economies to reduce demand or by restricting imports directly. Both of these are damaging to the borrowing countries, politically and socially disruptive, and painful to industrial economies like the United States -- because almost all of the reduction in LDC imports must come at the direct expense of exports from industrial countries.

But as the situation has developed in recent months, there has been a danger that lenders might move so far in the direction of caution that they compound the severe adjustment and liquidity problems already faced by major borrowers, and even push other countries which are now in reasonably decent shape into serious financing problems as well.

The question is one of the speed and degree of adjustment. While the developing countries must adjust their economies to reduce the pace of external borrowing and maintain their capacity to service debt, there _is_ a limit, in both economic and political terms, to the speed with which major adjustments can be made. Effective and orderly adjustment takes time, and attempts to push it too rapidly can be destabilizing.

Importance to the United States of an Orderly Resolution

It is right for American citizens to ask why they and their government need be concerned about the international debt problem. Why should we worry if some foreign borrowers get cut off from bank loans? And why should we worry if banks lose money? Nobody forced them to lend, and they should live with the consequences of their own decisions like any other business.

If all the U.S. government had in mind was throwing money at the borrowers and their lenders, it would be difficult to justify using U.S. funds on any efforts to resolve the debt crisis, especially at a time of domestic spending adjustment.

But of course, there _is_ more to the problem, and to the solution. First, a further abrupt and large-scale contraction of LDC imports would do major damage to the U.S. economy. Second, if the situation were handled badly, the difficulties facing LDC borrowers might come to appear so hopeless that they would be tempted to take desperate steps to try to escape. The present situation is manageable. But a downward spiral of world trade and billions of dollars in simultaneous loan losses would pose a fundamental threat to the international economic system, and to the American economy as well.

In order to appreciate fully the potential impact on the U.S. economy of rapid cutbacks in LDC imports, it is useful to look at how important international trade has become to us. Trade was the fastest growing part of the world economy in the last decade -- but the volume of U.S. exports grew even faster in the last part of the 1970's, more than twice as fast as the volume of total world exports. By 1980, nearly 20 percent of total U.S. production of goods was being exported, up from 9 percent in 1970, although the proportion has fallen slightly since then. (Charts C and D.)

Among the most dynamic export sectors for this country are agriculture, services, high technology, crude materials and fuels. American agriculture is heavily export-oriented: one in three acres of U.S. agricultural land, and 40 percent of agricultural production, go to exports. This is one sector in which we run a consistent trade surplus, a surplus that grew from $1.6 billion in 1970 to over $24 billion in 1980. (Chart E.)

Services trade -- for example, shipping, tourism, earnings on foreign direct investment and lending -- is another big U.S. growth area. The U.S. surplus on services trade grew from $3 billion in 1970 to $34 billion in 1980, and has widened further since. (Chart F.) When both goods and services are combined, it is estimated that one-third of U.S. corporate profits derive from international activities.

High technology manufactured goods are a leading edge of the American economy, and not surprisingly net exports of these goods have grown in importance. The surplus in trade in these products rose from $7.6 billion in 1970 to $30 billion in 1980. And even in a sector we do not always think of as dynamic -- crude materials and non-petroleum fuels like coal -- net exports rose six-fold, from $2.4 billion to $14.6 billion over the same period.

Vigorous expansion of our export sectors has become critical to employment in the United States. (Chart G.) The absolute importance of exports is large enough -- they accounted directly for 5 million jobs in 1982, including one out of every eight jobs in manufacturing industry. But export-related jobs have been getting even more important at the margin. A survey in the late 1970s indicated that four out of every five new jobs in U.S. manufacturing was coming from foreign trade; on average, it is estimated that every $1 billion increase in our exports results in 24,000 new jobs. Later I will detail how Mexican debt problems have caused a $10 billion annual-rate drop in our exports to Mexico between the end of 1981 and the end of 1982. By the rule of thumb I just gave, that alone -- if sustained -- would mean the loss of a quarter of a million American jobs.

These figures serve to illustrate the overall importance of exports to the U.S. economy. The story can be taken one step further, to relate it more closely to the present financial situation. Our trading relations with the non-OPEC LDCs have expanded even more rapidly than our overall trade. Our exports to the LDCs, which accounted for about 25 percent of total U.S. exports in 1970, rose to about 29 percent by 1980. (Chart H.) In manufactured goods, which make up two-thirds of our exports, the share going to LDCs rose even more strongly -- from 29 percent to 39 percent. In fact, since the mid-1970's trade with LDCs has accounted for more than half of the overall growth of American exports.

What these figures mean is that the export sector of our economy -- a leader in creating new jobs -- is tremendously vulnerable to any sharp cutbacks in imports by the non-OPEC LDCs. Yet that is exactly the response to which debt and liquidity problems have been driving them. This is a matter of concern not just to the banking system, but to American workers, farmers, manufacturers and investors as well.

Even on the banking side, there are indirect impacts of concern to all Americans. A squeeze on earnings and capital positions from losses on foreign loans not only would impair banks' ability to finance world trade, but also could ultimately mushroom into a significant reduction in their ability to lend to domestic customers and an increase in the cost of that lending.

Beyond our obvious interest in maintaining world trade and trade finance, there is another less-recognized U.S. financial interest. The U.S. government faces a potential exposure through Federal lending programs administered by Eximbank and the Commodity Credit Corporation. This exposure -- built in support of U.S. export expansion -- amounted to $35 billion at the end of 1982, including $24 billion of direct credits (mostly from Eximbank) and $11 billion of guarantees and insurance. Argentina, Brazil and Mexico are high on the list of borrowers. Should loans extended or guaranteed under these programs sour, the U.S. Treasury -- meaning the U.S. taxpayer -- would be left with the loss. We have a direct interest in avoiding this addition to Federal financing requirements.

All industrial economies, including the American economy, will inevitably bear some of the costs of the balance of payments adjustments LDCs must make and are already making. This adjustment would be much deeper, for both the borrowing countries and for lending countries like the United States, if banks were to pull back *entirely* from new lending this year. In 1983, for example, a flat standstill would require borrowers to make yet another $20 to $25 billion cut in their trade and current account deficits, which would be considerably harder to manage if it came right on the heels of similar cuts they have already made. Further adjustments are needed -- but again the question is one of the size and speed of adjustment. If these countries were somehow to make adjustments of that size for a second consecutive year, the United States and other industrial countries would then have to suffer large export losses once again. At the early stages of U.S. and world economic recovery we are likely to be in this year, a drop in export production of this size could abort the gradual rebuilding of consumer and investor confidence we need for a sustained recovery.

In fact, many borrowers have already taken very difficult adjustment measures to get this far. If they were forced to contemplate a second year of further massive cutbacks in available financing, they could be driven to consider other measures to reduce the burden of their debts. Here potentially lies a still greater threat to the financial system.

When interest payments are more than 90 days late, not only are bank profits reduced by the lost interest income, but they may also have to begin setting aside precautionary reserves to cover potential loan losses. If the situation persisted long enough, the capital of some banks might be reduced.

Banks are required to maintain an adequate ratio between their underlying capital and their assets -- which consist mainly of loans. For some, shrinkage of their capital base would force them to cut back on their assets -- meaning their outstanding loans -- or at least on the growth of their assets -- meaning their new lending. Banks would thus be forced to make fewer loans to all borrowers, domestic and foreign, and they would also be unable to make as many investments in securities such as municipal bonds. Reduced access to bank financing would thus force a cutback in the expenditures which private corporations and local governments can make -- and it would also put upward pressure on interest rates.

The usual perception of international lending is that it involves only a few large banks in the big cities, concentrated in half a dozen states. The facts are quite different. We have reliable information from bank regulatory agencies and Treasury reports identifying nearly 400 banks in 35 states and Puerto Rico that have foreign lending exposures of over $10 million -- and in all likelihood there are hundreds more banks with exposures below that threshhold but still big enough to make a significant dent in their capital and their ability to make new loans here at home. Banks in most states are involved, and the more abruptly new lending to troubled borrowing countries is cut back, the more likely it is that the fallout from their problems will feed back back on the U.S. financial system and weaken our economy. Many U.S. corporations also have claims on foreign countries, related to their exports and foreign investments.

Resolving the International Financial Problem

Debt and liquidity problems did not come into being overnight, and a lasting solution will also take some time to put into place. We have been working on a broad-based strategy involving all the key players -- LDC governments, governments in the industrialized countries, commercial banks, and the International Monetary Fund. This strategy has five main parts:

First, and in the long run most important, must be effective adjustment in borrowing countries. In other words, they must take steps to get their economies back on a stable course, and to make sure that imports do not grow faster than their ability to pay for them. Each of these countries is in a different situation, and each faces its own unique constraints. But in general, orderly and effective adjustment will not come overnight. The adjustment will have to come more slowly, and must involve expansion of productive investment and exports. In many cases it will entail multi-year efforts, usually involving measures to address some combination of the following problems: rigid exchange rates; subsidies and protectionism; distorted prices; inefficient state enterprises; uncontrolled government expenditures and large fiscal deficits; excessive and inflationary money growth; and interest rate controls which discourage private savings and distort investment patterns. The need for such corrective policies is recognized, and being acted on, by major borrowers -- with the support and assistance of the IMF.

The second element in our overall strategy is the continued availability of official balance of payments financing, on a scale sufficient to help see troubled borrowers through the adjustment period. The key institution for this purpose is the International Monetary Fund. The IMF not only provides temporary balance of payments financing, but also ensures that use of its funds is tied tightly to implementation of needed policy measures by borrowers.

It is this aspect -- IMF conditionality -- that makes the role of the IMF in resolving the current debt situation and the adequacy of its resources so important.

IMF resources are derived mainly from members' quota subscriptions, supplemented at times by borrowing from official sources. Assessing the adequacy of these resources over any extended period is extremely difficult and subject to wide margins of error. The potential needs for temporary balance of payments financing depend on a number of variables, including members' current and prospective balance of payments positions, the availability of other sources of financing, the strength of the conditionality associated with the use of IMF resources, and members' willingness and ability to implement the conditions of IMF programs. At the same time, the amount of IMF resources that is effectively available to meet its members' needs at any point in time depends not only on the size of quotas and borrowing arrangements, but also on the currency composition of those resources in relation to balance of payments patterns, and on the amount of members' liquid claims on the IMF which might be drawn. In view of all these variables, assessments of the IMF's "liquidity" -- its ability to meet members' requests for drawings -- can change very quickly.

Still, as difficult as it is to judge the adequacy of IMF resources in precise terms, most factors point in the same direction at present. The resources now effectively available to the IMF have fallen to very low levels in absolute terms, in relation to broad economic aggregates such as world trade, and in relation to actual and potential use of the IMF.

At the beginning of this year, the IMF had about SDR 28 billion available for lending. However, SDR 19 billion of that total had already been committed under existing IMF programs or was expected to be committed shortly to programs already negotiated, leaving only about SDR 9 billion available for new commitments. Given the scope of today's financing problems, requests for IMF programs by many more countries must be anticipated over the next year, and it is probable that unless action is taken to increase IMF resources its ability to commit funds to future adjustment programs will be exhausted by late 1983 or early 1984. I will return to our specific proposals in this area shortly.

The IMF cannot be our only buffer in financial emergencies. It takes time for borrowers to design and negotiate lending programs with the IMF and to develop financing arrangements with other creditors. As we have seen in recent cases, the problems of troubled borrowers can sometimes crystallize too quickly for that process to reach its conclusion -- in fact, the real liquidity crunch came in the Mexican and Brazilian cases before such negotiations even started.

Thus, the third element in our strategy is the willingness of governments and central banks in lending countries to act quickly to respond to debt emergencies when they occur. Recent experience has demonstrated the need to consider providing immediate and substantial short-term financing -- on a selective basis, where system-wide dangers are present -- to tide countries through their negotiations with the IMF and discussions with other creditors.

We are undertaking this where necessary, on a case-by-case basis, through ad hoc arrangements among finance ministries and central banks, often in cooperation with the Bank for International Settlements. But it must be emphasized that these lending packages are short-term in nature, designed to last for only a year at most and normally much less, and cannot substitute for IMF resources which are designed to help countries through a multi-year adjustment process.

In fact, IMF resources themselves have only a transitional and supporting role. The overall amount of Fund resources, while substantial, is limited and not in any event adequate to finance all the needs of its members. While we feel that a sizeable increase in IMF resources is essential, this increase is not a substitute for lending by commercial banks. Private banks have been the largest single source of international financing in the past to both industrial and developing countries, and this will have to be the case in the future as well -- including during the crucial period of adjustment.

Thus, the fourth essential element in resolving debt problems is continued commercial bank lending to countries that are pursuing sound adjustment programs. In the last months of 1982 some banks, both in United States and abroad, sought to limit or reduce outstanding loans to troubled borrowers. But an orderly resolution of the present situation requires not only a willingness by banks to "roll over" or restructure existing debts, but also to increase their net lending to developing countries, including the most troubled borrowers, to support effective, non-disruptive adjustment. The increase in net new commercial bank lending needed for just three countries -- Brazil, Argentina, and Mexico -- will approach $11 billion in 1983. Without this continued lending in support of orderly and constructive economic adjustment, the programs that have been formulated with the IMF cannot succeed -- and the lenders have a strong self-interest in helping to assure success. It should be noted, however, that new bank lending will be at a slower rate than that which has characterized the last few years -- more in line with the increase in 1982 than what we saw in 1980 or 1981.

The final part of our strategy is to restore sustainable economic growth and to preserve and strengthen the free trading system. The world economy is poised for a sustained recovery: inflation rates in most major countries have receded; nominal interest rates have fallen sharply; inventory rundowns are largely complete.

Solid, observable U.S. recovery is one critical ingredient missing for world economic expansion. We believe the U.S. recovery is now getting underway, as evidenced by the recent drop in unemployment and upturns in orders and production. Establishing credible growth in other industrial economies is also important and we believe the base for recovery is being laid abroad as well.

However, both we and others must exercise caution at this turning point. Governments must not give in to political pressures to stimulate their economies too quickly through excessive monetary or fiscal expansion. A major shift at this stage could place renewed upward pressure on inflation and interest rates.

In addition, rising protectionist pressures, both in the United States and elsewhere, pose a real threat to global recovery and to the resolution of the debt problem. When one country takes protectionist measures hoping to capture more than its fair share of world trade, other countries will retaliate. The result is that world trade shrinks, and rather than any one country gaining additional jobs, everybody loses. More importantly for current debt problems, we must remember that export expansion by countries facing problems is crucial to their balance of payments adjustment efforts. Protectionism cuts off the major channel of such expansion. That adjustment is essential to restoring problem country debtors to sustainable balance of payments positions and avoiding further liquidity crises -- and as we have seen, it is therefore essential to the economic and financial health of the United States.

The only solution is a stronger effort to resist protectionism. As the world's largest trading nation, the United States carries a major responsibility to lead the world away from a possible trade war. The clearest and strongest signal for other countries would be for the United States to renounce protectionist pressures at home and to preserve its essentially free trade policies. That signal would be followed, and would reinforce, continued U.S. efforts to encourage others to open their markets, and would in turn be reinforced by IMF program requirements for less restrictive trade policies by borrowers.

The Role and Resources of the IMF

I have stressed the role of the International Monetary Fund in dealing with the current financial situation, and now I would like to expand on that point. The IMF is the central official international monetary institution, established to promote a cooperative and stable monetary framework for the world economy. As such, it performs many functions beyond the one we are most concerned with today -- that of providing temporary balance of payments financing in support of adjustment. These include monitoring the appropriateness of its members' foreign exchange arrangements and policies, examining their economic policies, reviewing the adequacy of international liquidity, and providing mechanisms through which its member governments cooperate to improve the functioning of the international monetary system.

In that context, it becomes clearer that IMF financing is provided only as part of its ongoing systemic responsibilities. Its loans to members are made on a temporary basis in order to safeguard the functioning of the world financial system -- in order to provide borrowers with an extra margin of time and money which they can use to bring their external positions back into reasonable balance in an orderly manner, without being forced into abrupt and more restrictive measures to limit imports. The conditionality attached to IMF lending is designed to assure that orderly adjustment takes place, that the borrower is restored to a position which will enable it to repay the IMF over the medium term. In addition, a borrower's agreement with the IMF on an economic program is usually viewed by financial market participants as an international "seal of approval" of the borrower's policies, and serves as a catalyst for additional private and official financing.

The money which the IMF has available to meet its members' temporary balance of payments financing needs comes from two sources: quota subscriptions and IMF borrowing from its members. The first source, quotas, represents the Fund's main resource base and presently totals some SDR 61 billion, or about $67 billion at current exchange rates. The IMF periodically reviews the adequacy of quotas in relation to the growth of international transactions, the size of likely payments imbalances and financing needs, and world economic prospects generally.

At the outset of the current quota discussions in 1981, many IMF member countries favored a doubling or tripling of quotas, arguing both that large payments imbalances were likely to continue and that the IMF should play a larger intermediary role in financing them. While agreeing that quotas should be adequate to meet prospective needs for temporary financing, the United States felt that effective stabilization and adjustment measures should lead to a moderation of payments imbalances, and that a massive quota increase was not warranted. Nor did we feel that an extremely large quota increase would be the most efficient way to equip the IMF to deal with unpredictable and potentially major financing problems that could threaten the stability of the system as a whole, and for which the IMF's regular resources were inadequate.

Accordingly, the United States proposed a dual approach to strengthening IMF resources:

-- First, a quota increase which, while smaller than many others had wanted, could be expected to position the IMF to meet members' needs for temporary financing in normal circumstances.

-- Second, establishment of a contingency borrowing arrangement that would be available to the IMF on a stand-by basis for use in situations threatening the stability of the system as a whole.

This approach has been adopted by the IMF membership, in agreements reached by the major countries in the Group of Ten in mid-January, and by all members at the IMF's Interim Committee meeting last week.

The agreed increase in IMF quotas is 47 percent, an increase from SDR 61 billion to SDR 90 billion (in current dollar terms, an increase from $67 billion to $99 billion). The proposed increase in the U.S. quota is SDR 5.3 billion ($5.8 billion at current exchange rates) representing 18 percent of the total increase.

The Group of Ten, working with the IMF's Executive Board, has agreed to an expansion of the IMF's General Arrangements to Borrow from the equivalent of about SDR 6.5 billion at present to a new total of SDR 17 billion, and to changes in the GAB to permit its use, under certain circumstances, to finance drawings on the IMF by any member country. Under this agreement, the U.S. commitment to the GAB would rise from $2 billion to SDR 4.25 billion, equivalent to an increase of roughly $2.6 billion at current exchange rates.

We believe this expansion and revision of the GAB offers several important attractions and, as a supplement to the IMF's quotas, greatly strengthens the IMF's role as a backstop to the system:

-- First, since GAB credit lines are primarily with countries that have relatively strong reserve and balance of payments positions, they can be expected to provide more effectively usable resources than a quota increase of comparable size. Consequently, expansion of the GAB is a more effective and efficient means of strengthening the IMF's ability to deal with extraordinary financial difficulties than a comparable increase in quotas.

-- Second, since the GAB will not be drawn upon in normal circumstances, this source of financing will be conserved for emergency situations. By demonstrating that the IMF is positioned to deal with severe systematic threats, an expanded GAB can provide the confidence to private markets that is needed to ensure that capital continues to flow, thus reducing the risk that the problems of one country will affect others.

-- And third, creditors under this arrangement will have to concur in decisions on its activation, ensuring that it will be used only in cases of systemic need and in support of effective adjustment efforts by borrowing countries.

Annex A to my statement contains the texts of the relevant Interim Committee and Group of Ten communiques. These substantive agreements will be codified in formal Governors and Executive Board decisions in the next few weeks. In sum, the proposed increase in U.S. commitments to the IMF totals SDR 7.7 billion -- SDR 5.3 billion for the increase in the U.S. quota and SDR 2.4 billion for the increase in the U.S. commitment under the GAB. At current exchange rates, the dollar equivalents are $8.4 billion in total, $5.8 billion for the quota increase and $2.6 billion for the GAB increase.

We believe these steps to strengthen the IMF, if enacted, will safeguard the IMF's ability to respond effectively to current financial problems. Given the financing needs we foresee, we feel it is important that the increases be implemented by the end of this year. Without such a timely and adequate increase in IMF resources, the ability of the monetary system to weather debt and liquidity problems will be impaired, at substantial direct and indirect cost to the United States.

The U.S. share in the increase in IMF resources is 18 percent, which obviously means other countries are putting up the remaining 82 percent, the great bulk of the increase. By putting up 18 percent of the increase, we will maintain our voting share at just over 19 percent. The principle of weighted voting on which the IMF operates has been key to its effectiveness over the years and to ensuring that we have a voice and vote comparable to the share of resources we provide. Major policy decisions -- such as those just taken on the quota increase -- require an 85 percent majority vote, giving us a veto over all such decisions. Some of our allies would claim that we aren't pulling our own weight -- that our stake in world trade and finance is bigger than the share of resources we are proposing to put into the IMF would indicate.

Political and Security Interests

While fundamentally the IMF is designed to further our economic interests, in so doing it also benefits U.S. political and security interests. The IMF is essentially a non-political institution, with membership open to any country judged willing and able to meet the obligations of membership. But it serves our interests well by containing economic problems which could otherwise spread through the international community; as a stabilizing element in countries facing the social and economic dislocations which can accompany adjustment; and supporting open, market-oriented economic systems consistent with Western political values. Judged on this criterion, U.S. appropriations for the IMF can be an excellent investment if they can help to avoid political upheaval in countries of critical interest to the United States.

I said earlier that the IMF was formed out of conviction that a cooperative institution was needed to help prevent a recurrence of the Great Depression of the 1930s. But that is only half the story. The other half is that the Western leaders who joined together in 1944 set up the Fund did so in recognition of the fact that the economic and financial disruptions of the 1930s had been a major cause of World War II. "Beggar thy neighbor" policies that try to shift the burden of adjustment to other countries inevitably heighten worldwide political tensions -- and these are the policies that the IMF is meant to avoid. As volatile as the world environment has been at times in the postwar era, on balance it has been a period of unprecedented prosperity, and the international tensions we have experienced could only have been worse without the IMF.

Some observers have suggested that Fund programs create political instability in countries which use conditional financing by forcing unpopular economic measures on them. The process of economic adjustment is rarely pleasant -- but as we have seen, economic adjustment has to come in any event, with or without an IMF program. Without a program, adjustment can be abrupt and destabilizing. By making the process more rational and orderly, the IMF can help countries avoid unnecessary sacrifices and thereby minimize threats to their political stability.

IMF programs, technical assistance, and general policy advice all help to support greater reliance on decentralized, market-oriented economic systems. In practice this translates into IMF support for the private sector, freer markets, the use of price signals, and a whole array of policies that strengthen the individual's opportunity and incentive to respond and shape economic developments. It is a central tenet of the American experience that this is a prerequisite for a strong democratic system. Over time, this approach helps to foster economic institutions and philosophies that are conducive to democratic values.

In testimony on security and economic assistance last week, Secretary Shultz made the point that by improving economic conditions abroad these U.S. appropriations could avoid the necessity of sending our military forces abroad more often. He noted that there have been 185 incidents since the end of World War II in which our forces were sent overseas to protect U.S. economic or political interests. I would not want to stretch this point too far in relation to the IMF -- but surely here, too, it has some validity. The greater economic stability and reliance on sound economic policies that the IMF fosters can reduce the potential for political disruption.

Concerns about the Increase in IMF Resources

The general outline of our proposals has been known to members of Congress for some time. Many have expressed reservations or questions about this proposal, and I would like to discuss some of the main concerns now.

- Is the IMF "Foreign Aid"?

Many perceive money appropriated for IMF use to be just another form of foreign aid, and question why we should be providing U.S. funds to foreign governments. Let me assure you that the IMF is not a development institution. It does not finance dams, agricultural cooperatives, or infrastructure projects. I have already made the point that the IMF is a monetary institution. Only one of its functions is providing balance of payments financing to its members in order to promote orderly functioning of the monetary system, and only then on a temporary basis, on medium-term maturities, after obtaining agreement to the fulfillment of policy conditions. We have been working very hard with the IMF to ensure that both the effectiveness of IMF policy conditions, and the temporary nature of its financing, are safeguarded. In this way, the Fund's financing facilities will continue to have a revolving nature and to promote adjustment.

IMF conditionality has been controversial over the years, with strong opinions on both sides. Some observers have worried that conditionality is so weak and ineffective that conditional lending is virtually a giveaway. Others believe that conditionality is too tight -- that it imposes unnecessary hardship on borrowers, and stifles economic growth and development.

Such generalizations reflect a misunderstanding of IMF conditionality. When providing temporary resources to a country faced with external financing problems, the IMF seeks to assure itself that the country is pursuing policies that will enable it to live within its means -- that is, within its ability to obtain foreign financial resources. It is this that determines the degree of adjustment that is necessary. It is often the case that appropriate economic policies will strengthen a country's borrowing capacity, and result in both higher import growth and higher export growth. I would cite the example of Mexico as an immediate case in point.

Mexico is our third largest trading partner, after Canada and Japan. And, as recently as 1981, it was a partner with whom we had an export boom and a substantial trade surplus, exporting goods to meet the demands of its rapidly growing population and developing economy. This situation changed dramatically in 1982, as Mexico began experiencing severe debt and liquidity problems. By late 1982, Mexico no longer had access to financing sufficient to maintain either its imports or its domestic economic activity. As a result, U.S. exports to Mexico dropped by a staggering 60 percent between the fourth quarter of 1981 and the fourth quarter of 1982. Were our exports to Mexico to stay at their depressed end-1982 levels, this would represent a $10 billion drop in exports exports to our third largest market in the world. Because the financing crunch got worse as the year wore on, totals for the full year 1982 don't tell the story quite so dramatically -- but even they are bad enough. Our $4 billion trade surplus surplus with Mexico in 1981 was transformed into a trade deficit of nearly $4 billion in 1982, due mainly to an annual-average drop in U.S. exports of one-third. (Chart I.) This $8 billion deterioration was our worst swing in trade performance with any country in the world, and it was due almost entirely to the financing problem.

We believe that now this situation will start to turn around, and we can begin to resume more normal exports to Mexico. If this happens, it will be due in large part to the fact that, late in December, an IMF program for Mexico went into effect; and that program is providing the basis not only for IMF financing, but for other official financing and for a resumption of commercial bank lending as well. Mexico must make difficult policy adjustments if it is to restore creditworthiness. The Mexican authorities realize this and are embarked on a courageous program. But the existence of IMF financing and the other financing associated with it will permit Mexico to resume something more like a normal level of economic activity and imports while the adjustment takes place in an orderly manner. Without the IMF program, all we could look forward to would be ever-deepening depression in Mexico and still further declines in our exports to that country.

There is another aspect of the distinction between IMF financing and foreign aid which we should be very clear on, since it goes to the heart of U.S. relations with the Fund. All IMF members provide financing to the IMF under their quota subscriptions, and all -- industrial and developing alike -- have the right to draw on the IMF. Quota subscriptions form a kind of revolving fund, to which all members contribute and from which all are potential borrowers.

As an illustration, in practice our quota subscription has been drawn upon many times -- and repaid -- over the years for lending to other IMF members. We in turn have drawn on the IMF on 24 occasions -- most recently in November 1978 -- and our total cumulative drawings, amounting to the equivalent of $6.5 billion, are the second largest of any member (the United Kingdom has been the largest user of IMF funds). (U.S. drawings on the IMF are described at Annex B.)

- Do IMF Programs Hurt U.S. Exports?

There is a widespread perception that IMF programs are designed to cut imports by countries which use IMF financing, and thus hurt U.S. exports to those countries. Some would argue, in fact, that far from helping to maintain world trade and U.S. exports, our participation in the increase in IMF resources would contribute to further reductions in our exports.

This is simply a misreading of the IMF. The whole point of an IMF program is to get a borrower's external balance back within sustainable limits -- but to judge the effects of those programs on our exports you always have to start by asking what would have happened without an IMF program. When a country draws on IMF financing, it usually does so in recognition of the fact that its external deficit is not going to be sustainable if it stays on its present course. If the borrower didn't go to the IMF, it would likely be cut off from further external financing from other sources and would have to cut back drastically on imports, as we saw in the case of Mexico.

Furthermore, IMF programs are not just directed at slowing the growth of imports. Reducing import growth is often one of the short-run priorities, but even then IMF financing can permit a higher level of imports than would otherwise be the case. And equally important are steps to increase a country's export capacity, thereby giving it the ability to pay for higher imports in the long run.

Exchange rate devaluations are often an important part of IMF programs -- devaluations intended to ensure that the right price signals are sent to domestic producers, importers and exporters, and that the competitiveness of domestic industries is restored. These devaluations have often been accompanied by the removal of restrictions on trade and capital flows. And, to lay one total misunderstanding to rest, an IMF program never calls for the tightening of import restrictions -- in fact, new or intensified restrictions are expressly prohibited. The IMF does not promote restrictions -- its purposes and policies go precisely in the opposite direction.

- Why Not Spend the Money at Home?

Another major concern with the proposals to increase IMF resources is that, in this period of budgetary stringency, many believe we would be better advised to spend the money at home. There is also some feeling that if we were to get the U.S. economy moving forward again, the international financial problem would take care of itself. I think I've already been through part of the response to these concerns when I described the large and growing impact which foreign trade now has on American growth and employment. We will do what is necessary domestically to strengthen our economy. But we will leave a major threat to domestic recovery unaddressed if we do not act to resolve the international financial situation. The direct impact alone of international developments on our economy is so large that, were the international situation not to improve, there would at a minimum be a tremendous drag on our economic recovery.

It is true that an improving U.S. economy is going to help other nations, both through our lower interest rates and through an expanding U.S. market for their exports -- providing of course that we don't cut them off from that market. But they also have an immediate, short-run financing crunch to get through, and if we don't handle that right there are substantial downside risks for the United States.

This might also be the right context in which to discuss how U.S. participation in the increase in IMF resources would affect the Federal budget and the Treasury's borrowing requirements. Because the United States receives a liquid, interest-earning reserve claim on the IMF in connection with our actual transfers of cash to the IMF, such transfers do not result in net budget outlays or an increase in the Federal budget deficit.

Actual cash transactions with the IMF, under our quota subscription or U.S. credit lines, do affect Treasury borrowing requirements as they occur. An analysis appended to this statement at Annex C presents data on the impact of U.S. transactions between 1970 and 1982 on Treasury borrowing requirements. Although there have been both increases and decreases in Treasury borrowing requirements from year to year, on average there have been increases amounting to $454 million annually over the entire 13 year period, for a cumulative total of over $6 billion. The rate has picked up in the last two years of heavy IMF activity, as would be expected; but the total is still relatively small -- the $454 million annual impact is only a small part of the $54 billion annual average Federal borrowing requirement over the same period, and the $6 billion cumulative impact compares with an outstanding Federal debt of $1.2 trillion at the end of 1982. These figures also serve to demonstrate the revolving nature of the IMF.

- Is the IMF a Bank "Bail-Out"?

I also know there is a widespread concern that an increase in IMF resources will amount to a bank bail-out at the expense of the American taxpayer. Many would contend that the whole debt and liquidity problem is the fault of the banks -- that they've dug themselves and the rest of us into this hole though greed and incompetence, and now we intend to have the IMF take the consequences off their hands. This line of argument is dangerously misleading, and I would like to set the record straight.

First, the steps that are being taken to deal with the financial problem, including the increase in IMF resources, require continued involvement by the banks. Far from allowing them to cut and run, orderly adjustment requires increased bank lending to troubled LDCs that are prepared to adopt serious economic programs. That is exactly what is happening.

And it is not a departure from past experience. I have had Treasury staff review IMF program experience in the 20 countries which received the largest net IMF disbursements in the last few years, to see whether banks had been "bailed out" in the past. Looking at the period from 1977 to mid-1982, they found that for the countries which rely most heavily on private bank financing, IMF programs have been followed up by new bank lending much greater than the amount disbursed by the Fund itself. This also holds true for the 20 countries as a group: net IMF disbursements to this group during the period were $11.5 billion, while net bank lending totalled $49.7 billion, resulting in a ratio of 4.3 to 1 during this period.

Another point I would like to make is that the whole debt and liquidity problem cannot fairly be said to be the fault of the commercial banks. In fact, the banking system as a whole performed admirably over the last decade, in a period when there were widespread fears that the international monetary system would fall apart for lack of financing in the aftermath of the oil shocks. The banks managed almost the entire job of "recycling" the OPEC surplus and getting oil importers through that difficult period. Some of the innovations and decisions that banks made in the process, which seemed rational and necessary at the time to them and to others, may seem doubtful in retrospect, given the way the world economic environment changed. But I think we can agree that governments have had a great deal more to do with shaping that environment than banks.

All of this is not to say that there aren't lessons to be learned in the banking area -- there clearly has been an element of lack of prudence in lending decisions, and of overlending. So we should be asking ourselves: What is there that banks could be doing to improve their screening of foreign loans? What is there that bank regulators could do to improve on their analysis of country risk, examination of bank exposure, and consultations with senior management?

Our basic starting point in addressing these questions is a belief that the U.S. government should not get into the business of dictating the lending practices of private banks. Doing so would inject a political element into what should be business decisions, and would potentially expose the government to liability for covering loans that were not repaid on time. Moreover, in general it is bank managements, which have direct experience and a responsibility to their shareholders and depositors to motivate them, that are in the best position to make lending decisions.

In 1979, the bank regulatory agencies (the Federal Reserve, Comptroller of the Currency and the FDIC) instituted a new system for evaluating country risk, which has four elements. The first is a statistical reporting system designed to identify country exposures at each bank, and to enable regulators to monitor those exposures. Second is an evaluation of each bank's internal system for managing country risk, aimed at encouraging more systematic review of prospective loans. Third, where there is a judgment by regulators that a country has interrupted its debt service payments, or is about to do so, all loans to that country may be "classified" as substandard, doubtful, or a total loss, and such "classification" may trigger an obligation by the bank to set aside precautionary loan loss reserves. Fourth, bank examiners review and comment upon each bank's large foreign lending exposures, drawing upon the findings of an interagency committee of country analysts.

There are several possible changes that could be made in the regulatory environment. One would be to set up formal limits on each bank's exposure in different countries by law or regulation, in effect setting up "single country" limits analogous to the "single borrower" limits which are already used. Such limits on country exposure could be highly arbitrary and unable to distinguish among the capabilities of different banks or among the size and financial health of different countries -- particularly if dictated specifically, once and for all, in legislation. If limits were applied judgmentally, on the other hand, they could require that the U.S. government make controversial economic and political judgments about other countries. It may be feasible and desirable to do something more along these lines, but we should not put ourselves in too tight a corner on either count, and thus should try to leave as much scope as possible for bank regulators to work out the details.

Another possibility, which has been discussed with banks here and abroad, would be to require banks to meet specific criteria in establishing precautionary loan loss reserves against troubled loans, or against particularly large ones. Current procedures are not uniform across banks, and since setting aside such reserves reduces current earnings, there is some reluctance to do so unless absolutely required.

Both in the banking regulatory agencies, and at the Treasury, we will be reviewing these and other issues to see what changes might be desirable. We need to be careful in determining how to deal with such a sensitive and central part of our economy. Any decisions in this area will have important implications both for resolving the present situation, and for the evolution of the banking system in the future.

The Multilateral Development Banks

I would like to close with some remarks about our proposals for U.S. participation in the multilateral development banks (MDBs). This year, the Administration will be seeking Congressional approval of legislation to authorize U.S. participation in replenishments of the Inter-American Development Bank, the Asian Development Bank, and the African Development Fund.

The MDBs are proven, effective instruments for promoting economic growth and development, and our participation in the MDBs represents a significant part of both present and projected U.S. foreign assistance. We have been making a major effort to further improve the effectiveness of these institutions so as to maximize the contribution they make to sustainable economic development.

The objectives of MDB programs are markedly different from those of the IMF. The IMF provides temporary financing designed to support orderly adjustment and to safeguard the functioning of the international monetary system. Its resources are available for drawing by all members. In contrast, the MDBs lend primarily to finance portions of specific investment projects. MDB financing is longer term -- 20 years or more -- and it is available only to developing countries.

Given the leadership role of the United States in the international community and the great diversity of U.S. interests, we must be able to deliver on the internationally negotiated funding arrangements for the MDBs. To this end, the Administration has consulted closely with the Congress both before and during the MDB funding negotiations.

When these have been completed, we will be proposing legislation to authorize appropriations of $960 million for the concessional lending programs of the Inter-American and Asian Development Banks and the African Development Fund. This respresents a 24.5 percent reduction from the previous replenishments for these programs. At the same time, other donors will be providing more than $4 billion.

Agreements are nearing completion for the replenishment of resources of the Inter-American and Asian Development Banks. When these are completed, we will be proposing legislation to authorize an increase in U.S. participation in the African Development Fund and the capital and concessional lending programs of the Inter-American and Asian Development Banks. These are larger in total than the previous replenishments -- but U.S. subscriptions will require less budget authority, since the development banks will rely more heavily on the private market and there will be an overall reduction in the concessional windows.

The African Development Fund (AFDF)

Draft legislation authorizing a U.S. contribution to the third replenishment of the African Development Fund was submitted to the 97th Congress but was not enacted. U.S. participation in this replenishment is not only an important way of demonstrating our continued commitment to economic growth and development in the world's least developed continent, but also reflects increased U.S. economic, political, and security interests in that region.

As a result of provisions contained in the replenishment agreement, the Fund currently has a backlog of approved loans that cannot be signed until the United States agrees to participate in the replenishment and makes its first payment. The replenishment, which is to finance lending in the 1982-84 period, totals about $1.1 billion. The proposed U.S. share is $150 million, or 14 percent of the total. Appropriations for the first $50 million installment would be provided under the FY 1983 Continuing Resolution and the two remaining installments will be sought in fiscal years 1984 and 1985.

Inter-American Development Bank (IDB) Sixth Replenishment

While negotiations for the Sixth Replenishment of the Inter-American Development Bank have not been concluded, we expect the final agreement to entail U.S. budgetary outlays at a lower level than the previous replenishment. Our present expectation is that this replenishment will provide a $13 billion lending program funded over a four-year period beginning in fiscal 1984, and will call for a capital increase of $14.8 billion, with a paid-in component of 4.5 percent. We also expect agreement to a replenishment of the Fund for Special Operations (FSO) totalling $725 million. The overall replenishment would result in U.S. capital subscriptions of $5,156 million, with paid-in capital of $232 million ($58 million annually) and callable capital of $4,924 million ($1,231 million annually), and in U.S. contributions to the FSO of $290 million ($72.5 million annually).

This proposed replenishment is consistent with the recommendations of the Administration's MDB Assessment for reduction of soft window contributions and paid-in capital, while still providing assistance to the poorest developing countries. The FSO would be about $1 billion less than that of the last replenishment, with total budgetary saving to the United States as compared to the previous replenishment of $384 million. This will be the first IDB replenishment where all borrowing member countries provide all of their paid-in capital subscriptions and FSO contributions in convertible currency, a solid example of the willingness of the more advanced developing countries to assume greater responsibility in the international economic system.

In order to obtain support for the scaled-back FSO replenishment, the United States agreed to the establishment of an Intermediate Financing Facility (IFF) to be targeted at the region's poorer countries. Funding for the IFF would come from FSO net income and FSO general reserves, and would be combined with regular hard loans. The IFF would be used to lower the interest cost on IDB hard window loans by approximately 5 percentage points and, as presently envisioned, would not require any new contributions.

Inter-American Investment Corporation (IIC)

Partially modeled after the International Finance Corporation, the Inter-American Investment Corporation would be a separate entity which provides development assistance to the private sector in Latin America and the Caribbean. The member countries of the Inter-American Development Bank have discussed formation of such a Corporation for a number of years and a meeting will be held this month to finalize an agreement on the capitalization of the IIC. Assuming there is adequate support from other IDB member countries, we currently envision U.S. subscriptions of up to $20 million annually over four years, beginning in FY 1984.

The Asian Development Bank (Third GCI)

We expect negotiations to conclude soon on the third general capital increase to finance ADB's ordinary capital lending for the CY 1983-1987 period. ADB management has moved from an initial proposal for a 125 percent GCI with 10 percent paid-in to a proposal for a 105 percent GCI with 5 percent paid-in. We expect to join a consensus of ADB member countries on this proposal in the near future.

In terms of U.S. budgetary costs, the current proposal represents a U.S. paid-in capital subscription of $66.2 million ($13.2 million annually) and a U.S. callable capital subscription of $1,257 million ($251.4 million annually) over five years.

Asian Development Fund

During 1982, the Administration completed negotiations on the fourth replenishment of the Asian Development Fund and now seeks authorization of U.S. participation in the replenishment.

The U.S. $520 million share of the proposed replenishment is 16.25 percent of the total as compared to a 22 percent U.S. share in the previous replenishment. Appropriations of $130 million annually will be sought in the four year period from FY 1983 through 1986.

Conclusion

The IMF plays a crucial role in the solution to current debt and liquidity problems, and in providing the environment for world recovery. It is absolutely essential that the proposed increase in IMF resources become effective by the end of this year, to enable the IMF to meet these responsibilities. Prompt U.S. approval is important not only because the financing is needed, but also because it would be a sign of confidence to other governments and to the public, and would help lay to rest concerns about the risks to global recovery.

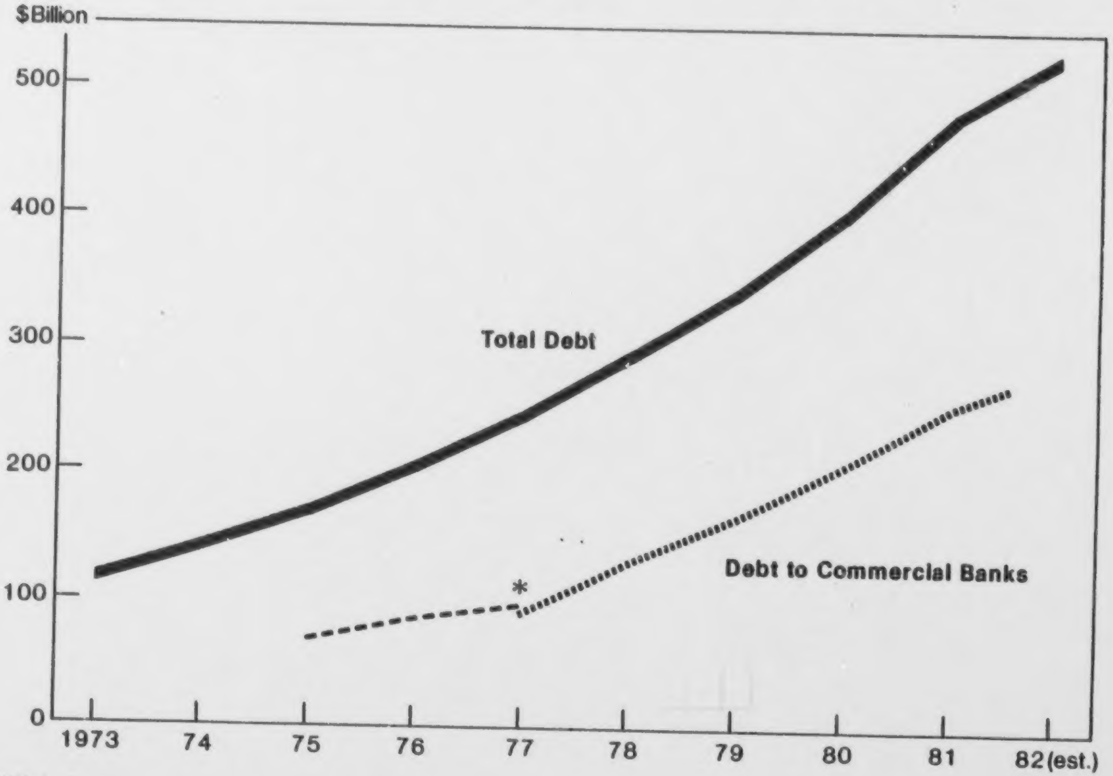
But most importantly, timely approval of these proposals is essential to our own economic interests -- to the prospects for American businesses and American jobs. The legislation will be submitted to you in a very few days. I urge that you give it prompt and favorable consideration.

Both the IMF and the multilateral development banks also serve broader U.S. political and security interests. To the rest of the world they are a sign that the bulwark of democracy is also a responsible partner in international economic affairs. To the poorer nations of the world the multilateral development banks are also tangible evidence of the support by Western nations for sustainable economic development. And of direct benefit to the United States, they help to foster political stability and democratic values in the developing world.

I have tried to lay out a number of reasons for the United States to support the IMF and the MDBs. Some of these are at least partly altruistic, but the majority relate to our own self-interest. I urge your strong support for the proposed U.S. appropriations for these institutions.

Chart A

OUTSTANDING FOREIGN DEBT OF NON-OPEC LDCs

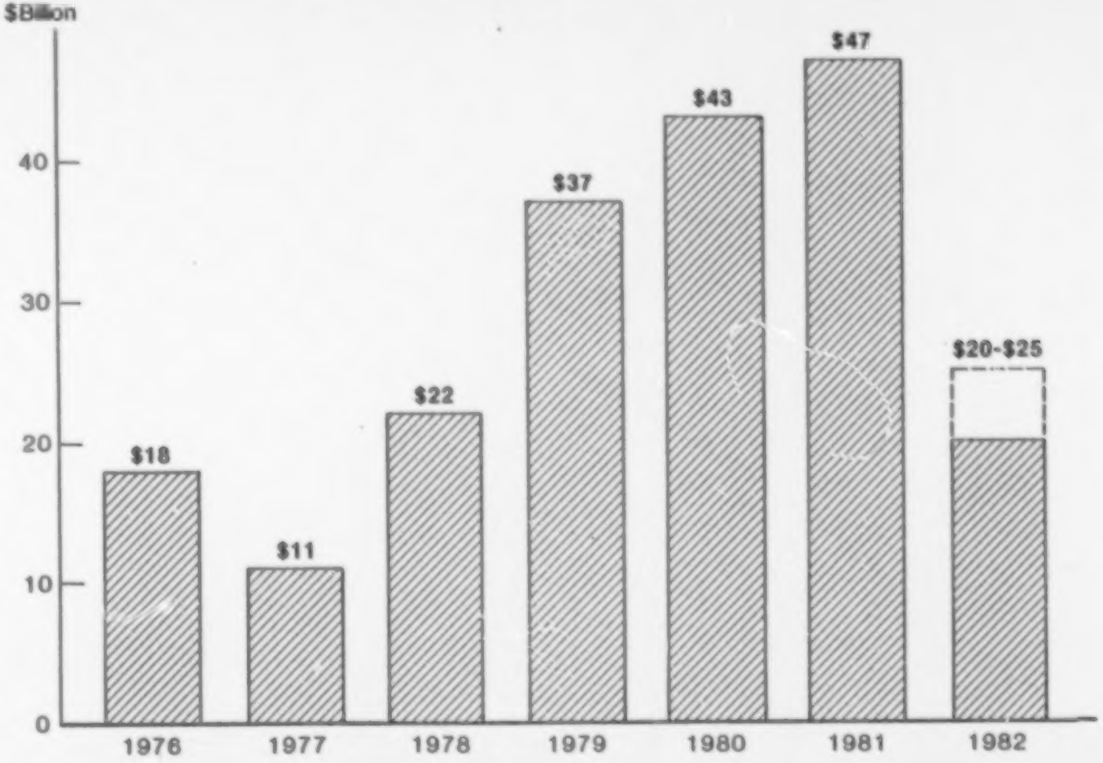


* Series break.

U.S. Treasury Dept.
2-11-83

Chart B

NET NEW LENDING BY COMMERCIAL BANKS TO NON-OPEC LDCs



U.S. Treasury Dept.
2-11-83

Chart C

GROWTH OF U.S. AND WORLD EXPORT VOLUME

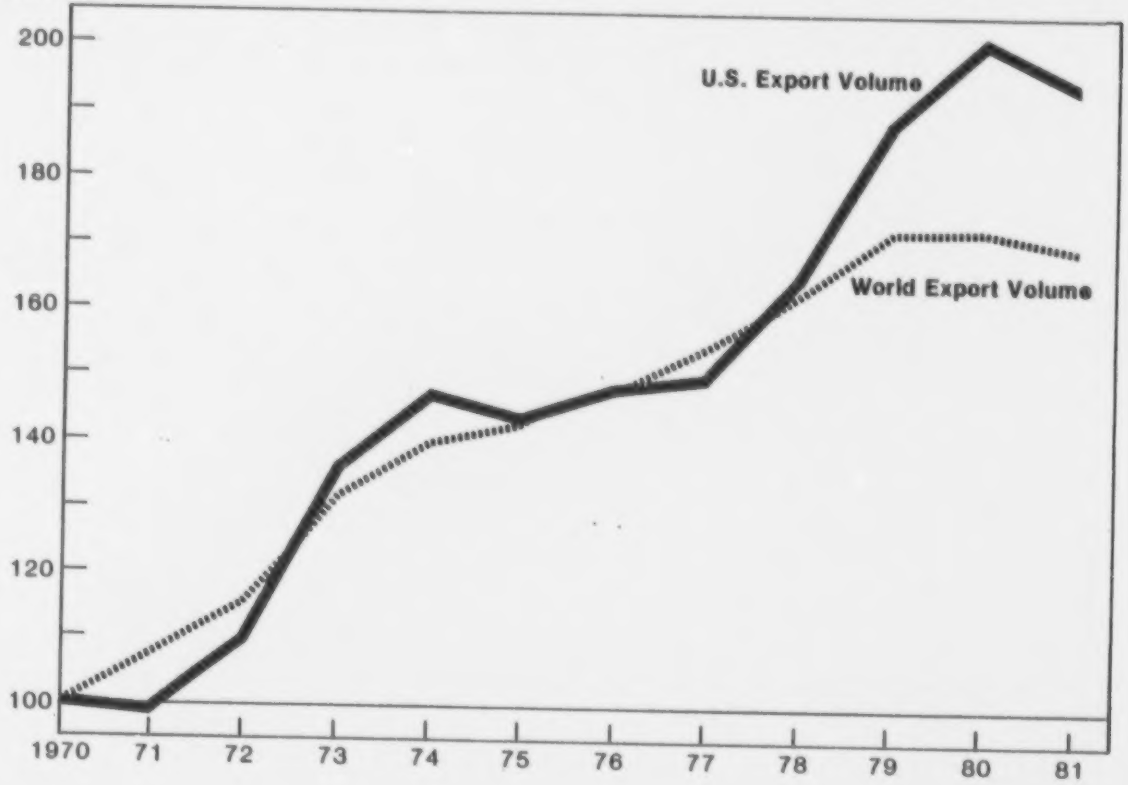
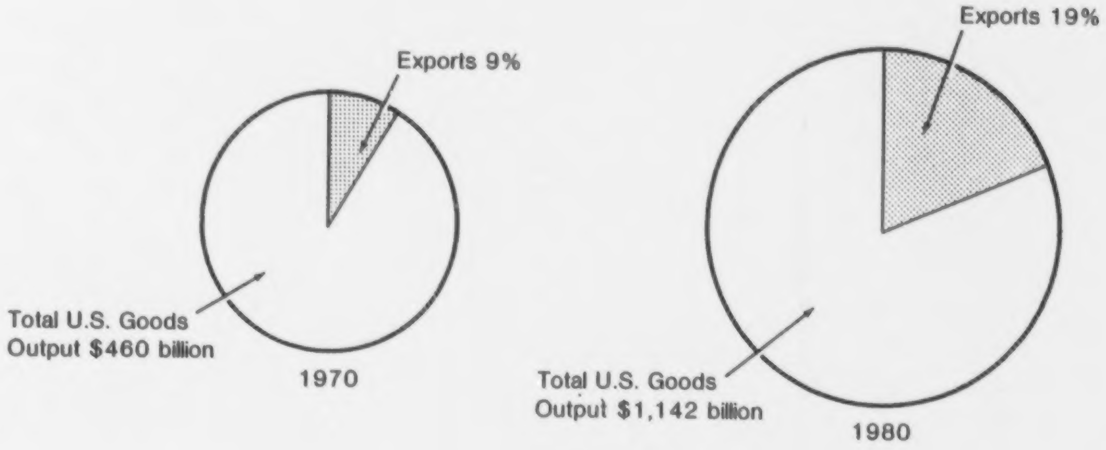


Chart D

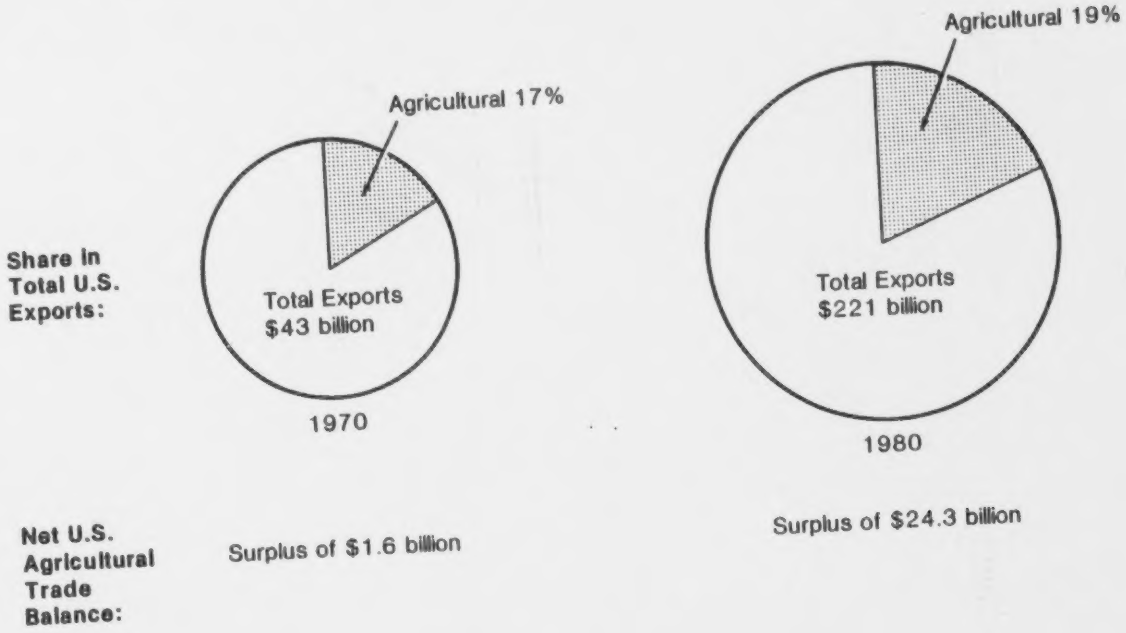
SHARE OF U.S. EXPORTS IN TOTAL U.S. GOODS OUTPUT



U.S. Treasury Dept.
2-11-83

Chart E

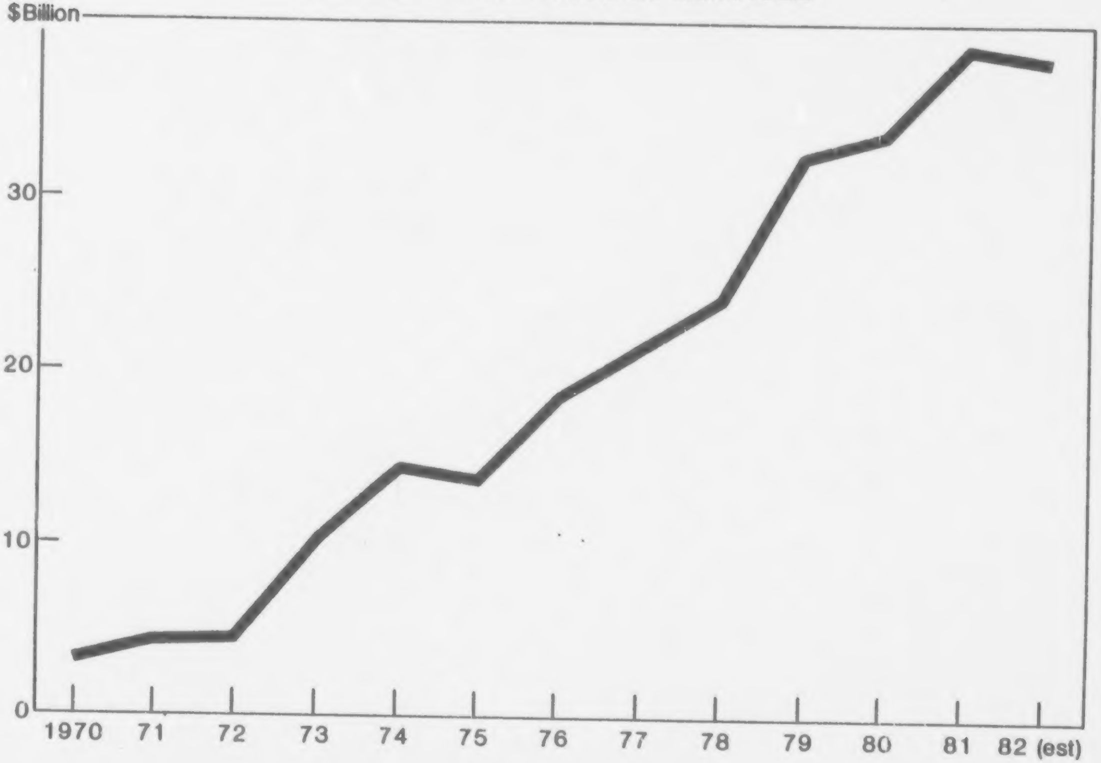
U.S. AGRICULTURAL EXPORTS



U.S. Treasury Dept.
2-11-83

Chart F

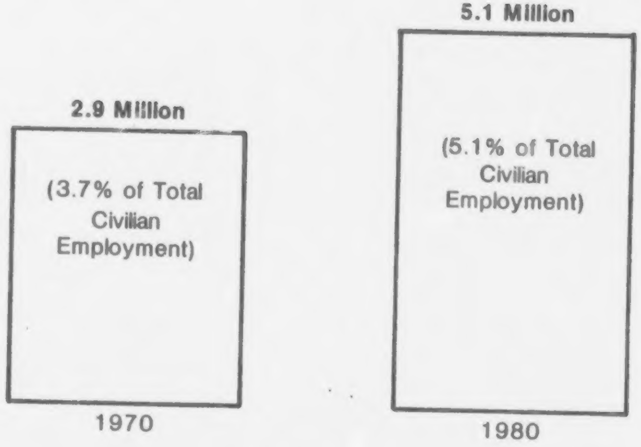
U.S. TRADE BALANCE IN SERVICES



U.S. Treasury Dept.
2-11-83

Chart G

U.S. EXPORT-RELATED JOBS



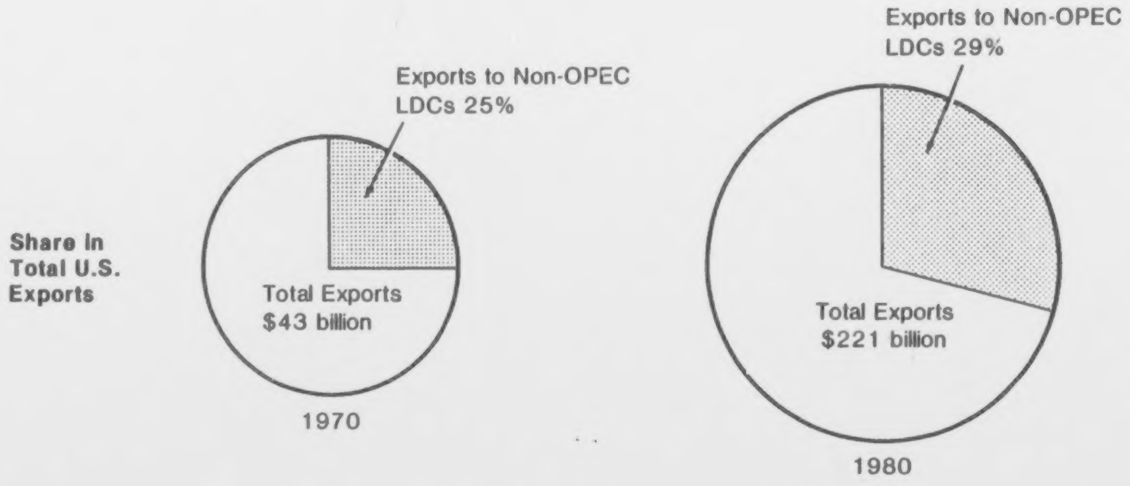
As of 1980, each $1 billion of U.S. exports was estimated to result in 24,000 jobs.

Source: Commerce Department (ITA) estimates.

U.S. Treasury Dept.
2-11-83

Chart H

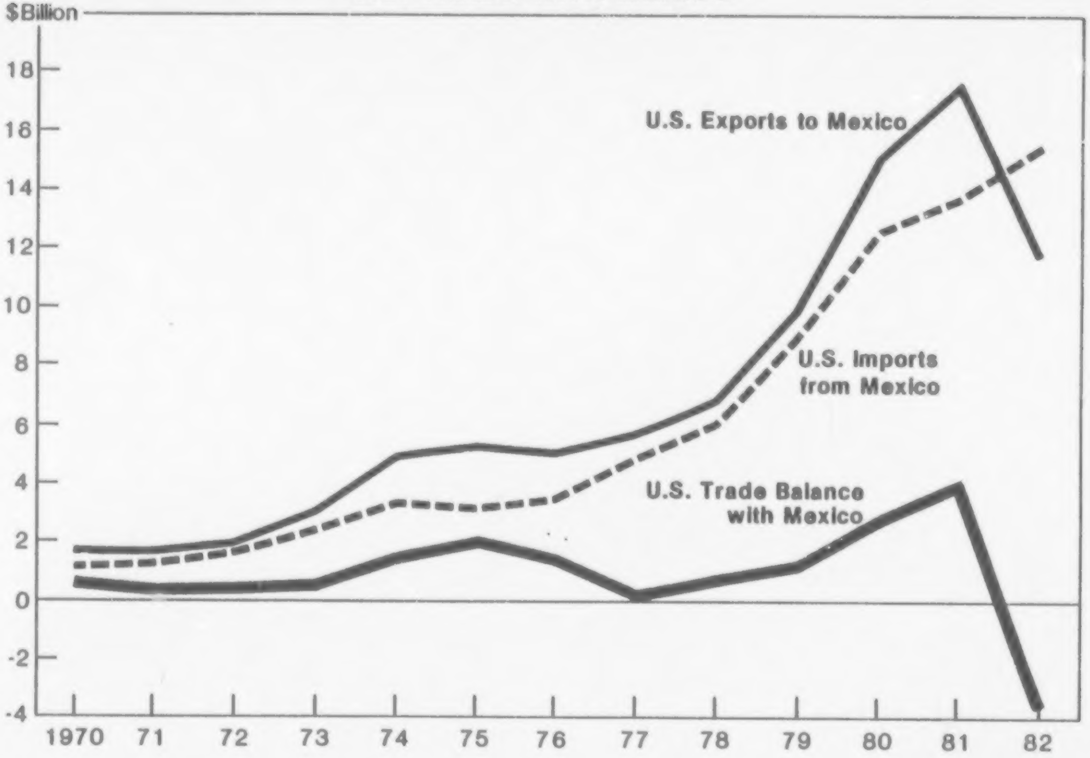
U.S. EXPORTS TO NON-OPEC LESS DEVELOPED COUNTRIES



U.S. Treasury Dept.
2-11-83

Chart I

U.S. TRADE WITH MEXICO



U.S. Treasury Dept.
2-11-83

APPENDIX A

INTERNATIONAL MONETARY FUND

Press Release NO. 83/11

FOR IMMEDIATE RELEASE
February 11, 1983

Press Communiqué of the Interim Committee of the Board of Governors of the International Monetary Fund

1. The Interim Committee of the Board of Governors of the International Monetary Fund held its twentieth meeting in Washington, D.C., on February 10 and 11, 1983, under the chairmanship of Sir Geoffrey Howe, Chancellor of the Exchequer of the United Kingdom. Mr. Jacques de Larosière, Managing Director of the International Monetary Fund, participated in the meeting. The meeting was also attended by observers from a number of international and regional organizations and from Switzerland.

2. The Committee discussed the World Economic Outlook and the policies needed to cope with the difficult problems faced by most members of the Fund.

The Committee noted that estimated rates of both growth of output and inflation had been revised downward since its previous meeting in September 1982. Anxiety was expressed at the high level of unemployment and the weakness of investment and world trade, against the background of only limited indications of economic recovery. At the same time, the Committee welcomed the further progress made by some of the larger industrial countries in their fight against inflation, as well as the reduction in interest rates that had been facilitated by this progress--developments that were providing the basis for a sustainable recovery in economic activity.

Believing that successful handling of the inflation problem is a necessary--albeit not sufficient--condition for sustained growth over the medium term, the Committee urged national authorities, in their efforts to promote sustained recovery, to avoid measures that might generate harmful expectations with regard to inflation. The importance of reducing fiscal deficits in a number of countries was also emphasized. Otherwise, the Committee noted, high real interest rates detrimental to the process of recovery could be generated by market expectations regarding government borrowing requirements.

It was the Committee's view that, in several major industrial countries where inflation remained relatively high, present circumstances called for continued restraint in monetary and fiscal policies, along with effective implementation of the incomes policies now in place. It was felt, however, that conditions for economic recovery had improved in those large industrial countries that have been able to achieve the greatest measure of success in reducing and controlling inflation. This success--and the reduction in interest rates that it has permitted--provided the basis, within the pursuit of counter-inflationary monetary and fiscal policies, for greater real growth of activity. The transition to a more stable path of real growth would be further facilitated by determined efforts to reduce market rigidities and structural imbalances.

The Committee deplored the upsurge of protectionist pressures in the past year or two. It stressed the paramount importance of resisting these pressures and, indeed, rolling them back.

The unsatisfactory situation facing non-oil developing countries was a source of particular concern to the Committee, which noted that growth rates in these countries, after averaging about 6 per cent in the 1960s and early 1970s, had averaged only 2 1/2 per cent during the past two years and were not expected to show much improvement in 1983. The Committee also observed that the modest recent increases in output, which were barely sufficient to keep pace with rapid population growth, had been achieved against a background of deteriorating terms of trade, sluggish markets for exports, high interest rates in international financial markets, and strains in the financing of current account deficits. These conditions had necessitated a sharp compression of imports by the non-oil developing countries--which, in turn, had been achieved at the cost of lower investment and growth.

Noting the extent of the external adjustment already achieved by many non-oil developing countries and the uncertainties that most such countries face in financing their current account deficits, the Committee attached great importance to the continuing provision of both official development assistance and private banking flows on an adequate scale, and it welcomed the special role recently played by the Fund in this connection.

More generally, the Committee stressed the enhanced importance, in current circumstances, of the Fund's role in providing its balance of payments assistance to member countries that engage in adjustment programs and in exercising firm surveillance over policies, and also the need to equip the Fund with adequate resources to perform this role.

3. The Committee, noting the progress made by the Executive Board on the various issues of the Eighth General Review of Quotas, focused its attention on the remaining issues, and took satisfaction in being able to reach the following agreement on the subject of quotas:

(a) The total of Fund quotas should be increased under the Eighth General Review from approximately SDR 61.03 billion to SDR 90 billion (equivalent to about US$ 98.5 billion).

(b) Forty per cent of the overall increase should be distributed to all members in proportion to their present individual quotas, and the balance of sixty per cent should be distributed in the form of selective adjustments in proportion to each member's share in the total of the calculated quotas, i.e., the quotas that broadly reflect members' relative positions in the world economy.

(c) Twenty-five per cent of the increase in each member's quota should be paid in SDRs or in usable currencies of other members.

The Committee considered the possibility of a special adjustment of very small quotas, i.e., those quotas that are currently less than SDR 10 million. It was agreed to refer this matter to the Executive Board for urgent consideration in connection with the implementation of the main decision.

4. The question of the limits on access to the Fund's resources was raised in the Committee. It was noted that the Executive Board will review this matter before June 30, 1983. The Committee invited the Executive Board to take note of the views expressed in the Committee by those favoring maintenance of the present enlarged limits in terms of multiples of quotas and also by those stressing the need to have regard to developments in the Fund's liquidity. It also invited the Managing Director to report on this matter at the next meeting of the Committee.

5. The Committee noted the recent decision of the Finance Ministers and Central Bank Governors of the participants in the General Arrangements to Borrow (GAB) to support an increase in the total amount of the commitments under these Arrangements to SDR 17 billion (equivalent to about US$19 billion) and to make the resources of these Arrangements available to the Fund to finance also purchases by nonparticipants when the Fund faces an inadequacy of resources arising from an exceptional situation involving a threat to the stability of the international monetary system. In this connection, the Committee welcomed the intention of Switzerland to become a full participant in the Arrangements, through the Swiss National Bank, with a credit commitment of SDR 1,020 million.

The Committee also welcomed the willingness of Saudi Arabia to provide resources to the Fund, in association with the GAB, and for the same purposes as those of the GAB. They noted with satisfaction the progress that is being made in setting out the detailed features of this association.

6. The members of the Committee requested the Executive Board to adopt, before the end of February 1983, the necessary decisions and other actions to implement the consensus reached in the Committee. They also agreed to urge the governments of their constituencies to act promptly so that the proposals for the increase in the Fund's resources could be made effective by the end of 1983.

7. The Committee considered again the question of allocations of SDRs in the current, i.e., the fourth, basic period which began on January 1, 1982. Noting the developments since its Toronto meeting, the Committee agreed that the matter should be reexamined as soon as possible. It, therefore, requested the Executive Board to review the latest trends in growth, inflation and international liquidity, with a view to enabling the Managing Director to determine, not later than the next meeting of the Interim Committee, whether a proposal for a new SDR allocation could be made that would command broad support among members of the Fund.

8. The Committee agreed to hold its next meeting in Washington, D.C., on September 25, 1983.

January 19, 1983

Press Communique of the Ministers and Governors of The Group of Ten

1. The Ministers and central bank Governors of the ten countries participating in the General Arrangements to Borrow (GAB) met in Paris on January 18, 1983 under the chairmanship of Mr. Jacques Delors, Minister of Economy and Finance of France. The Managing Director of the International Monetary Fund (IMF), Mr. Jacques de Larosière, took part in the meeting, which was also attended by Mr. F. Leutwiler, President of the Swiss National Bank, Mr. E. Van Lennep, Secretary-General of the Organisation for Economic Cooperation and Development (OECD), Mr. A. Lamfalussy, Assistant General Manager of the Bank for International Settlements, and Mr. F.-X. Ortoli, Vice-President of the Commission of the European Communities.

2. The Ministers and Governors heard a report by the Chairman of their Deputies, Mr. Lamberto Dini, on issues relating to the revision and expansion of the GAB and the Eighth General Review of Quotas of the IMF. They also heard a report by the Chairman of the Working Party No. 3 of the Economic Policy Committee of the OECD, Mr. Christopher Mcmahon, on the world economic outlook.

3. In addressing the world economic situation, the Ministers and Governors welcomed recent successes in the fight against inflation and prospects for further progress. They looked toward sound monetary and fiscal policies and appropriate moderation in the growth in incomes to encourage lower interest rates, expanding trade, higher employment, and durable economic growth. These desirable developments must not be thwarted by trade restrictions or by disruption of the international financial system. At the same time, it was recognized that soundly based growth would itself help ease current tensions. To these ends, the Ministers and Governors affirmed their support for a reinforced cooperation among industrialized countries on economic, financial, and trade policies. They considered that a sustainable improvement in activity in the industrial countries in 1983 can make an important contribution to a lasting solution of the indebtedness problem of many developing countries and to limiting the unemployment problem in all countries. Therefore, they noted with satisfaction that the competent international organizations will examine whether further steps can be taken to ensure renewed and sustained growth, and will report to the next ministerial councils, notably in the OECD and IMF framework.

4. Against this background, the Ministers and Governors discussed the international financial situation. They noted that, while strains remained in the system and the foreign debt problems of a number of countries were still a cause for real concern, governments and monetary authorities had been cooperating actively and effectively with international monetary institutions and commercial banks to reinforce the stability of the system. In order to ensure the continuing ability of the financial system to cope with existing strains and to facilitate the adjustment process, they strongly supported a substantial increase of resources available to the International Monetary Fund.

5. In light of the foregoing, the Ministers and Governors have decided, subject to the necessary legislative approval, that their aggregate credit commitments under the GAB should be promptly increased—from SDR 6.4 billion to SDR 17 billion (equivalent to an increase from $7.1 billion to about $19 billion). They welcomed the intention of Switzerland to become a full-scale participant in the GAB and decided that necessary adjustments in the arrangements should be made so as to permit the participation of Switzerland at an early date. They also decided an adjustment of the participants' shares in the arrangements so as to reflect better their size and role in the international economy and their ability to provide financial resources. A list of the new credit commitments that have been agreed is attached. They further agreed that in the future the GAB would be available not only for drawings by participants but also for purchases from the Fund for conditional financing for all its members, including members that are not GAB participants, when the Fund was faced with an inadequacy of resources arising from an exceptional situation associated with requests from countries with balance of payments problems of a character or of aggregate size that could pose a threat to the stability of the international monetary system.

6. The Ministers and Governors also looked to the conclusion of arrangements with other countries that might be willing and able to provide substantial resources to the Fund for the same purposes and on terms not unlike those agreed under the GAB. In this regard, the Ministers and Governors welcomed the recent contacts that the Chairman of the Group of Ten, and the

Chairman of the Interim Committee and the Managing Director of the Fund, have had with the authorities of Saudi Arabia. They asked the Chairman of the G-10 Deputies, in collaboration with the Managing Director of the IMF, to resume such contacts as soon as possible.

7. The Ministers and Governors discussed the issues related to the Eighth General Review of Quotas. They agreed that a substantial overall increase was called for. They also recognized the need for a meaningful adjustment of quota shares in the Fund to bring these more in line with the relative position of member countries in the world economy.

8. The Ministers and Governors noted that substantial progress had been made on the Quota Review issues, and were of the view that the conditions were now present for reaching conclusions at the forthcoming meeting of the Interim Committee on February 10-11, 1983. They emphasized the desirability of having new quotas in effect by the end of 1983.

9. The Ministers and Governors expressed their gratitude to the French authorities for their cordial hospitality and for the excellent meeting arrangements.

Attachment

ATTACHMENT

GAB Credit Commitments for G-10 Countries and Switzerland

	In millions of SDRs	Shares in per cent
United States	4,250.0	25.00
Germany	2,380.0	14.00
Japan	2,125.0	12.50
France	1,700.0	10.00
United Kingdom	1,700.0	10.00
Italy	1,105.0	6.50
Canada	892.5	5.25
Netherlands	850.0	5.00
Belgium	595.0	3.50
Sweden	382.5	2.25
Switzerland	1,020.0	6.00
Total	17,000.0	100.00

APPENDIX B

IMF Drawings by the United States

The United States has drawn on the International Monetary Fund (IMF) on twenty-four occasions over the past 19 years for a total of about SDR 5.8 billion (equivalent to about $6.5 billion at the exchange rates prevailing at the time of each drawing), the second largest amount of cumulative drawings of any IMF member. None of these drawings was subject to IMF policy conditionality, as they all involved drawings on the U.S. reserve position in the IMF. Drawings on the reserve position are available automatically upon representation of balance of payments need; do not bear interest and are not subject to repurchase obligations; and do not involve policy conditionality.

The U.S. drawings were for the following purposes: during the 1960s and early 1970s they were designed to limit foreign purchases of U.S. gold reserves; subsequently, they were designed to provide the United States with foreign currencies for the purpose of exchange market operations. These purposes are explained below. A table listing all U.S. drawings is attached.

Drawings During the 1960s and 1970s

Under the international monetary arrangements in operation following World War II, each member of the IMF was required to establish and maintain a "par value" for its currency in terms of gold. The United States undertook to fulfill its par value obligations by standing ready to convert dollars held by foreign monetary authorities into gold at the official price of $35 per ounce -- i.e., the par value of the dollar. Other countries met their par value obligations by maintaining exchange rates for their currencies -- directly or indirectly -- in terms of the dollar within narrow margins. In this manner, a strucuture of currency exchange rates linked to gold was established and maintained.

During the 1950s and 1960s, large payments imbalances, substantial losses of U.S. gold and foreign accumulations of dollar holdings, representing further potential strains on U.S. gold, put increasing strain on this system. Beginning in the early 1960s the United States, in cooperation with foreign monetary authorities, initiated a variety of measures designed to limit pressures on U.S. gold holdings. U.S. drawings on the IMF were an integral part of this program.

In general, IMF drawings provided the United States with foreign currencies that could be used to purchase dollars from foreign monetary authorities and thus reduce demands for conversion of official dollar holdings to gold. The foreign currencies obtained from the IMF were used most often in the following types of transactions:

- to facilitate repayment of IMF drawings by other countries without necessitating the use of U.S. gold:
- repayment of U.S. short-term currency swaps with foreign central banks; and
- direct purchases by the United States of foreign official dollar holdings that would otherwise be used to purchase U.S. gold.

Drawings Since the Early 1970s

With the end of the par value/gold convertibility arrangements in the early 1970s, the basic purpose of U.S. drawings from the IMF was to finance U.S. intervention in the exchange markets in support of the dollar. During the 1970s, the U.S. intervened directly in the foreign exchange market, buying and selling foreign currencies for dollars, in order to deal with exchange market pressures on the dollar. The foreign currencies obtained from U.S. drawings in the IMF provided an important source of funds for such intervention. In November 1978, a U.S. drawing of $3 billion of German marks and Japanese yen was a component of a major program of U.S. and foreign intervention in the exchange market to support the dollar.

IMF Drawings by the United States
(SDR Millions)

Date		Amount
1964:	Feb	125
	June	125
	Sept	150
	Dec	125
	Total	525
1965	March	75
	July	300
	Sept	60
	Total	435
1966	Jan	100
	March	60
	April	30
	May	30
	July	71
	Aug	282
	Sept	35
	Oct	31
	Nov	12
	Dec	30
	Total	681
1968:	March	200
	Total	200
1970:	May	150
	Total	150
1971:	Jan	250
	June	250
	Aug	862
	Total	1,362
1972:	April	200
	Total	200
1978:	Nov	2,275
	Total	2,275
Grand Total		5,828 1/

1/ Equivalent to about $6.5 billion at exchange rates prevailing at the time of each drawing.

APPENDIX C

Budgetary and Accounting Treatment of Transactions with the IMF under the U.S. Quota in the IMF and U.S. Loans to the IMF

Under budget and accounting procedures established in consultation with the Congress at the time of the 1980 increase in the U.S. IMF quota, an increase in the U.S. quota or line of credit to the IMF requires budget authorization and appropriation for the full amount of increases in the quota or U.S. lending arrangements. The sum is included in the budget authority totals for the fiscal year requested. Payment to the IMF of the increased quota subscription is made partly (25 percent) in reserve assets (SDRs or foreign currencies) and partly in non-interest bearing letters of credit, which are a contingent liability. Under the credit lines established pursuant to IMF borrowing arrangements with the United States, the Treasury is committed to provide funds upon call by the IMF.

A budget expenditure occurs only as cash is actually transferred to the IMF, through the 25 percent reserve asset payment, through encashment of the quota letter of credit, or against the borrowing arrangements. Simultaneous with such transfers, the U.S. receives an equal offsetting receipt, representing an increase in the U.S. reserve position in the IMF -- an interest-bearing, liquid international monetary asset that is available unconditionally to the United States in case of balance of payments need. As a consequence of these offsetting transactions, transfers to the IMF under the quota subscription or U.S. lending arrangements therefore do not result in net budget outlays, or directly affect the budget deficit. Similarly, payments of dollars by the IMF to the United States (for example, resulting from repayments by other IMF member countries) do not result in net budget receipts since the U.S. reserve position declines simultaneously by a like amount.

Transfers from the United States to the IMF under the U.S. quota or U.S. lending arrangements increase Treasury borrowing requirements, while transfers from the IMF to the United States improve the Treasury's cash position and reduce its borrowing requirement. The net effect of transfers to and from the IMF has varied widely over the years, resulting in cash outflows from the Treasury in some years and inflows to the Treasury in other years. Moreover, Treasury interest costs on borrowings to finance any net transfers to the IMF need to be balanced against the remuneration (interest) earned on the U.S. reserve position in the IMF. Finally, the U.S. may incur exchange gains and losses on the U.S. reserve position in the IMF due to changes in the dollar value of the SDR.

It is not possible to project the effect on Treasury borrowing requirements or the net cost of U.S. transactions with the IMF because of uncertainties regarding the future level of IMF financing; the portion of such financing that would be in dollars; and movements in market interest and exchange rates. However, the figures in the attached table indicate that for the period from May 1, 1969 to the end of 1982:

-- Net increases in Treasury borrowing requirements attributable to transactions with the IMF averaged $454 million annually, compared to average annual increases in Federal borrowing of $54 billion.

-- Treasury debt outstanding attributable to transactions with the IMF averaged $1.6 billion annually. This is not an annual increase in Treasury borrowing, but an estimate of the average total debt outstanding each year attributable to cumulative U.S. transactions with the IMF. As of December 31, 1982, the outstanding borrowing attributable to such transactions amounted to $6.3 billion, about 1/2 of 1 percent of the total outstanding Treasury debt of $1.2 trillion.

-- Net interest costs to the Treasury associated with all U.S. transactions with the IMF averaged $42 million annually. In fiscal 1982, interest costs on total Treasury debt amounted to $117 billion.

-- Net annual valuation losses to the U.S. on the U.S. reserve position in the IMF averaged $69 million.

-- The overall net annual cost to the U.S., taking account of interest and valuation, thus averaged $111 million.

Estimated Gains and Losses Associated With U.S. Transactions Under U.S. Quota and U.S. Loans to IMF

(millions of dollars)

Year Ended April 30 1/	Cumulative Net Treasury Debt(-) or Cash(+) Position Arising From: Transactions Under U.S. Quota 2/ (1)	U.S. Loans to IMF 3/ (2)	Total 4/ (3)	Borrowing Cost(-) or Reduction(+) from Column(3) 5/ (4)	Interest Received by U.S. on Loans to IMF 6/ (5)	Remuneration Received by U.S. from IMF 7/ (6)	Valuation Gains(+) or Losses(-) on U.S. Reserve Position 8/ (7)	Interest Earned on Holdings of Foreign Currencies Drawn from IMF 9/ (8)	Total Net Gains(+) or Losses(-) 10/ (9)
1970	-716	-	-716	-50	-	+13	-	-	-37
1971	-702	-	-702	-38	-	+12	-	-	-26
1972	+445	-	+445	+19	-	*	-	-	+19
1973	+811	-	+811	+39	-	-	+34	-	+73
1974	+704	-	+704	+54	-	-	+54	-	+108
1975	-300	-	-300	-22	-	*	+70	-	+48
1976	-940	-	-940	-52	-	+9	-182	-	-225
1977	-2,695	-131	-2,826	-138	+3	+79	+54	-	-2
1978	-2,726	-639	-3,365	-197	+26	+79	+219	-	+127
1979	-1,368	-329	-1,697	-140	+28	+30	+223	+25	+166
1980	-555	-16	-571	-65	-	-	+15	+46	-4
1981	-1,294	-334	-1,628	-192	+16	+22	-203	+63	-294
1982	-3,416	-862	-4,278	-581	+88	+216	-1,134	+75	-1,336
1983 thru 12/31/82	-5,092	-1,216	-6,308	-364	+64	+222	-94	+39	-133
Total Period: 5/1/69–12/31/82				-1,727	+225	+682	-944	+248	-1,516
Annual Average	-1,306	-258	-1,564	-126	+16	+50	-69	+18	-111

Footnotes

*Indicates less than $500,000.

1/ Represents IMF fiscal year.

2/ Includes U.S. transfers of dollars to the IMF (i.e., an outflow of dollars from Treasury) and dollar balances received by the U.S. from the IMF and from sales of foreign currency drawn by the U.S. from the IMF (i.e., an inflow of dollars to the Treasury).

3/ Includes U.S. loans and repayments under the IMF's General Arrangements to Borrow and Supplementary Financing Facility.

4/ Transfers to and from the IMF under the U.S. quota subscription or U.S. lending arrangements result in budget outlays and simultaneous receipts of U.S. reserve position in the IMF; these transactions have a zero effect on net outlays and the budget deficit.

5/ Equals column 3 times average Treasury 3-month bill rate during period. Payments enter the U.S. budget as interest on the public debt; inflows reduce Treasury's need to borrow and thus reduce interest expense.

6/ Enters the U.S. budget as a receipt.

7/ Remuneration on U.S. creditor position; prior to 1975, remuneration was 1.5%, although special income distributions were made in 1970 and 1971 which raised the effective rate to 2.0 percent in those years. From 1975, the rate was based on short-term market interest rates in the five largest IMF members (U.S., U.K., Germany, France, Japan). Enters the U.S. budget as a receipt. Payments are made by IMF annually, as of April 30; FY 1983 figure represents net accrual as of December 31, 1982.

8/ Reflects changes in the dollar value of the U.S. reserve position in the IMF due to an appreciation (-) or depreciation (+) of the dollar in terms of the SDR. Enters the U.S. budget as a positive or negative net outlay.

9/ Interest earned on investments of German marks and Japanese yen acquired from U.S. drawing on IMF in November 1978. Enters the U.S. budget as part of the net profit or loss of the Exchange Stabilization Fund of the Treasury, recorded as a positive or negative net outlay.

10/ Equal to the sum of columns 4 through 8.

The CHAIRMAN. Thank you, Mr. Secretary, very much.

We will go on a 10-minute time limit because of the number of Senators we have this morning.

First, I would like to ask you to be as specific as you can about the role that the IMF plays in solving economic problems which could otherwise spread throughout the international community. You have indicated that IMF limits itself to providing balance-of-payments financing on a temporary basis, but only after obtaining agreement to economic conditions.

We are increasingly a "have not" nation—80 percent of our raw materials now come from abroad. We used to be a huge exporter of oil. We are now a huge importer of oil.

We depend upon a stable world. We just had a real problem in the Sudan with Libya. I was in Sudan just a year ago. The IMF has placed stringent conditions on Sudan in exchange for helping them with their balance-of-payments problems. They were subsidizing, for instance, food like sugar. They had to increase the price 60 percent. It caused a lot of domestic unrest.

I could not see any possibility Sudan could take these measures unless they were working under the edict of the IMF saying, "This is something you have to do for your own long-run good."

Are there other examples that you can provide where working toward stability in important parts of the world is in our interest as well as the interest of those countries that IMF uniquely can play a role in?

Secretary REGAN. I think, Mr. Chairman, I could point to practically the entire area of Latin America as an area now where most of the nations are in trouble because they have tried to further their own social programs, which indeed is a good political goal. But nevertheless, they tried to go too fast. As a result, they borrowed too much and then, when commodity prices fell, they all got into trouble.

I am not just here referring to oil, oil is merely the latest. If you take a nation such as Brazil, where their chief exports include iron ore and soybeans as well as coffee and rubber and things of that nature, all of those commodities fell at one time.

This nation, as a result, could not cover its imports, primarily oil. So, it was running a trade deficit. At the same time, it had run up these large debts in order to pay for some of the social programs and some of the infrastructure that they needed to develop Brazil as a nation.

The net result of all of this is that they have to take stringent measures. Now, theoretically it would be politically possible to do this on your own but it is much more feasible when you have an outsider telling you to do it. It is much easier to explain the situation to the populace if you can say that you must do this "because we are being told this by an international agency, the IMF, to do it." It makes it that much easier for the nation to undergo the effort. It is a temporary thing, a couple of years, and usually the nation recovers.

I have been checking recently to find out, and while Sudan and Zaire and some other nations have required successive IMF program, all have paid back IMF loans and has been the better off as a result of the programs.

That is why we say that the IMF is the one body in the world that is nonpolitical and monetary in its nature, but yet a necessity for any country that gets into trouble.

The CHAIRMAN. Thank you.

Could you also address yourself once again to the single most important economic problem we now have in this country—unemployment—and the relationship that IMF funding has to developing export markets?

I mention this because we are all from agricultural States. In Illinois, one out of two farmers is engaged in export. In the cities of Decatur, Springfield, Rockford, Peoria, one out of four in manufacturing is engaged in exports.

How important is this replenishment and this financial assistance to IMF by the United States? What relationship will that have to creating more jobs in this country, opening up more export markets abroad?

Secretary REGAN. The nations that are currently under IMF programs and the nations that may likely be under IMF programs in the near future, are all customers of the United States, as well as friends of the United States. They import quite a bit from the United States.

As I showed in one of my charts there, 19 percent of all of our goods output is going into the export business. We must have that, or else one out of every five jobs in the production of goods could be lost in the United States. The more we can export, the more jobs we have at home.

To the extent that these nations are unable to import from us because they have defaulted on their debt, certainly, no bank is going to finance a defaulter. But a nation that is struggling but has an IMF program and is able to get by or get through a temporary period of difficulty, is in a much better position to continue its imports.

That was what I was trying to point out with my Mexican example. Mexico without an IMF program would have to default on its debt. Mexico defaulting on its debt would not be able to be financed by anyone for quite some time to come. But Mexico with an IMF program and with additional bank help is able to continue, continue its imports to a limited extent. But nevertheless, once it gets out of that it will again become one of our best customers.

So, if we do not have the Mexicos or the Brazils of the world as our customers, we certainly are going to have a worse economy here and more unemployment.

The CHAIRMAN. You have mentioned in your testimony that this will provide the environment for world recovery. Specially, if the Congress failed to authorize this replenishment, in your judgment what would be the effect on U.S. economic recovery and world recovery, which are both intertwined?

Secretary REGAN. Well, the majority of the other nations of the world will be watching us, and if the United States does not go along with this, they will not go. As a result, the IMF will not have a quota increase.

It is our judgment that the IMF with its current commitments and the possibility of some nearby future commitments, will probably need additional resources at the end of the year or certainly early on in 1984. If it lacks this, it will not be able to carry out these programs. Once one nation falls, who knows what happens from then on. All banks will draw back, not just U.S. banks but British banks or French banks or German banks or Japanese banks.

If the banks of the world draw back, you have no international financing, then, for international trade. Without an international financing system, there is no international trade.

So, what I would be projecting would be, if we do not get this is, gradually the world's economy is going to grind to a standstill, and that is not going to do our recovery at home here any good at all.

The CHAIRMAN. I concur with you on that. It is a judgmental factor but I think your reasoning is absolutely sound and the forecast is regretfully accurate, if we do not act.

There has been a suggestion that the IMF quota increase should be transmitted as a fiscal year 1983 supplemental rather than a fiscal year 1984 request. Does Treasury have a position on this particular suggestion?

Secretary REGAN. We have been working recently with OMB and with both the Senate and House committees on this. We have not reached a final conclusion but I am leaning right now toward a 1983 supplemental rather than 1984.

I think that everyone knows the necessity for speed here. The fastest way would be on a 1983 supplemental, provided all of the participating committees agree, rather than waiting for the 1984 budget and its process.

What I want to inject here at this point is that this is merely budget authority, as the committee knows, I believe.

The CHAIRMAN. Yes.

Secretary REGAN. The use of dollars in IMF drawings is very small. Over the years it has been averaging about half a billion dollars a year. In the last 2 years, the drawings on the U.S. quota have increased to just over $1 billion per year.

When the time comes for the IMF to draw on that U.S. quota in calendar 1983, 1984, and the next few years, we would go into the market to borrow the necessary funds.

I know another fear is that this might tend to crowd out. But we are borrowing this year $224 billion. Next year, hopefully, it will be a lot less than that. But nevertheless, it will still be in the neighborhood—well, we are projecting a deficit of $184 billion plus the off-budget, a little less than $200 billion.

So, to borrow an extra half billion or $1 billion on top of $200 billion is not that great a deal.

The CHAIRMAN. I concur. It will put it on a much faster track, I think.

Finally, there has been a suggestion, just as the administration stretched out the World Bank replenishment—the sixth replenishment for an extra year—there has been a suggestion that the $8.4 billion request should be stretched out over several years.

What is your view on this suggestion?

Secretary REGAN. Well, as I just suggested in my answer to the previous question, the drawdown on the U.S. quota is stretched out over a period of years. The quota increase is for a 5-year period and the drawdown of the $5.8 billion U.S. increase would be over a number of years.

I do not anticipate much drawing if ever on the $2.7 billion for the GAB. That is supposed to be a special insurance fund drawn on only in emergencies, not drawn on regularly. So, I would not anticipate much drawing down on that in the 5-year period.

On the $5.8 billion, probably that would be drawn over the 5-year period. That is a stretchout of itself. But it should all be authorized at one time so that the IMF for planning purposes knows what it has and what it can draw on. And then the spreadout on the drawdown.

The CHAIRMAN. Thank you very much.

Senator Lugar?

Senator LUGAR. Thank you, Mr. Chairman.

Mr. Secretary, I concur with the chairman's thoughts and I gather you agree that this ought to proceed in a 1983 supplementary budget.

Obviously, you have testified many times about the urgency of the situation. In fact, it is very clearly apparent, and dramatically so, on the chart that still is left from your testimony on the result of financing and precipitous drop in our export market in Mexico. This problem still continues.

Now, without doubt we need to move rapidly with regard to the IMF support and replenishment. But I suppose the fear that most of us have—and you are uniquely qualified to testify on this—is the monumental developments occurring in the oil market presently.

None of us has any idea what the extent of this will be, but this may be one of the most significant happenings in many years with regard to rearrangement of all of international finance. We know specifically that the impact upon Mexico will be very substantial. Although we do not know precisely how that chart will change. It could be that we will be importing more energy resources from Mexico for a smaller fee.

But in the case of Mexico alone, is the IMF plan which you now are privy to or at least working with, going to be adequate to assist Mexico through this very trying period of time? Usually, people point out—and I would agree with this—that the fall of the price of oil is an unallied good. But Mexico will need to be assisted in some way.

Now, how is that to proceed, and does the IMF picture fit that, and how much more will be required beyond that?

Secretary REGAN. Well, it is complicated and we have to throw a lot of "ifs" into the answer because none of us knows precisely just how the oil situation is going to play out.

We estimate that Mexico loses $500 million for each dollar-a-barrel drop in oil prices. So, a drop in the price of oil of $5 to about $26 is $2.5 billion.

But there is another equation that you have to quickly put into effect here, and that is that a drop of 1 percent in interest rates costs saves Mexico, since they have a debt of over $80 billion, it will save Mexico something on the order of $700 million.

The question is, How much will the drop in the price of oil be reflected in a drop in inflation cost worldwide, which in turn should drop real rates of interest, which in turn should drop nominal rates of interest? You have quite a linkage there. So, it is "on the one hand" and "on the other hand."

On balance, we think that under current conditions and oil at the price that I said, it looks as though the program should be sufficient for Mexico. If it is not, obviously adjustments will have to be made. If you have to think the unthinkable—which is a precipitous drop to $20 a barrel in the Mexican situation—that would add a new dimension to the problem and we would have to restudy their problem.

But I think under current conditions of what we know now about the drop in oil prices, that the IMF program and the additional funds that are being put up by commercial banks around the world should be sufficient to carry Mexico through that program.

Senator LUGAR. Is the equation essentially that which you have suggested, a $5 a barrel decrease, which means that the $2.5 billion they lose could be made up by a 3-percent decline in interest rates? Obviously, there are other factors involved. But is this at least a part of the hope?

Secretary REGAN. That is part of the solution that we are looking at, yes. Obviously a lot depends upon whether they have a floating rate of interest or they are tied to a fixed rate of interest on some of their loans.

Also, what are the contracts that they have signed up for their oil. Are some of their oil prices at fixed contracts above the spot price or are they on a floating rate, also.

So, you have to take all of these things into consideration. But shorthand would say that that is a trade off.

Senator LUGAR. Yesterday—and this is very topical—the interest rate on U.S. Treasury notes and bonds declined somewhat. Most long-term bonds went up a full point or more, so that at least the market appeared to be reflecting the thought that the decline in oil prices would lead to lower interest rates, even in the long-term situations.

In your professional judgment is this the likely course of affairs?

Secretary REGAN. Well, that, coupled with a sensible monetary policy and hopefully a sensible fiscal policy, will result in lower rates of interest here in the United States.

But even LIBOR, the London Inter-Bank Rate, dropped yesterday, it dropped below 9 percent, it is at 8⅞. So. LIBOR is coming down also, which means that worldwide interest rates are starting to decline.

Hopefully, again with the admonishment that we have to have a good fiscal and monetary policy, interest rates should be coming down.

Senator LUGAR. But in fact the entire scenario of the International Monetary Fund depends upon that, does it not? If interest rates head the other way, substantially the other way, then the amounts of money in this replenishment are not adequate; are they?

Secretary REGAN. Well, again, it depends upon why the interest rates are going up. If interest rates are going up because oil prices are going up, for example, then Mexico and other oil exporting countries benefit. As it stands now, there are more oil-importing countries than exporting. So, a drop in the price of oil is better for the world.

Senator LUGAR. There are more winners in that.

Secretary REGAN. There are more winners than losers, yes.

Senator LUGAR. Secretary Regan, obviously in the dialog you had with the chairman today, he on each occasion—as has Senator Mathias—has tried to demonstrate this point that in a very real sense the IMF replenishment is a "jobs bill." That is a popular term for some, not for all.

But at least for most of us who are in States that have very high unemployment it is a very important point. It somehow, in the popular vernacular, just has not gotten through.

I think we are all struggling with the popular thought that somehow the IMF replenishment or strengthening is a way of taking bankers who have made bad decisions off the hook. For this reason all sorts of suggestions are being made about restrictions on loans and even countries.

I have no idea how the U.S. Treasury or the administration, or the Senate as a whole, can get the point across that any movement toward less unemployment in this country must involve aggressive exporting, and that financing must in fact be there or the Mexican case becomes replete in many other ways.

I think this is at the heart of the political debate on this subject. I just want to ask you the question, how can we get across the point that it is not only our 2 out of 5 acres in Indiana, Illinois, and Kansas, and what have you, that we are going to export? I think all of the agricultural community knows this. But in the industrial community we have not yet gotten this point across.

I am concerned about this and wonder if you have any further comment about it.

Secretary REGAN. It is a massive educational job. We are doing the best that we can to publicize this not only in appearances by many of the Cabinet here on the Hill. Treasury officials and the like, but we are also talking wherever we can find an audience regarding this. So that we do try to get publicity on it, news stories, things of that nature.

Most people, I am afraid, are quite unacquainted with what IMF really stands for. They are thinking of it in terms of IDA, some type of giveaway program or soft loan window, long-range do-good types of projects, that amount to nothing.

Far from it. That is why I stressed in my remarks that the IMF is a monetary institution and it is a fund that was created primarily under the aegis of America with the thought in mind that we somehow or other had to take care of nations that got into temporary difficulties.

That is all it is, it is an international agency for temporary loans to nations in trouble in order to keep world trade going.

Senator LUGAR. Thank you very much.

The CHAIRMAN. Thank you, Senator Lugar. Senator Mathias?

Senator MATHIAS. Thank you, Mr. Chairman.

Mr. Secretary, just following up that last point, it might be interesting to the committee to reflect on who the largest users of the IMF have been historically.

Secretary REGAN. No. 1 is Great Britain, they are the largest user of the International Monetary Fund. No. 2 is the United States, we are the second-largest user of the International Monetary Fund over its history. We have gone there some 24 times, I believe it is, for a total of $6.5 billion—not loans but just drawing down the rights that we have in the Fund.

Senator MATHIAS. So the record is that it is a truly international fund and not just developing nations use it but the developed nations use it as well.

Secretary REGAN. Both, industrialized and developing nations have used the International Monetary Fund to their advantage.

Senator MATHIAS. I would like to go back, if we could, to your charts A and B because I think they are extremely valuable and they also point out one of the dangers in this picture.

In chart A you very graphically illustrate the rise of the total outstanding foreign debt of non-OPEC developing countries. And the dotted line plots the debts to commercial banks which is not perfectly clear on the chart but which, I believe, is now about 65 percent of the total; is it?

Secretary REGAN. That is correct, yes.

Senator MATHIAS. So that a substantial part of that debt is due to the private sector.

Chart B illustrates the current trend in the 1982 reports. I think you may have stage managed this to have that chart supported by an article in today's Washington Post, written by Caroline Atkinson and James L. Rowe, Jr., commenting on the dangerous situation in which the private sector is retrenching.

They report, for example, that the Riggs National Bank has cut interbank deposits with Brazilian institutions from $43 million last June to $8 million earlier this year; the First Minneapolis from $32 million to $5 million; the National Bank of Detroit from $75 million to $8 million; National City Bank of Cleveland from $33 million to $7 million; First Interstate of Los Angeles from $81 million to $43 million; Rainier Bank in the Pacific Northwest from $14.5 million to zero.

Now, what you are proposing by way of an increased quota for IMF depends on the cooperation, the continuing cooperation of the private sector; does it not?

Secretary REGAN. It has to. The IMF cannot do it by itself.

Senator MATHIAS. So, chart B is a very dangerous development.

Secretary REGAN. Yes; that is what we are stressing, that if the banks pull back too much and become too conservative as far as their lending practices abroad, they will impede international trade. Much of that money that is used, the commercial bank portion of it, is used in financing trade, either of short or longer duration.

Now, to the extent that it is not financed, there will be no trade—which means less exports for us, less imports, and the like.

Senator MATHIAS. Slower recovery?

Secretary REGAN. Oh, much slower recovery.

Senator MATHIAS. Fewer jobs?

Secretary REGAN. Has to be because, again one out of eight jobs in manufacturing is dependent upon overseas trade.

Senator MATHIAS. Now, in fact rather than cutting back what appears to be more than half—as I look at your chart—in 1982, the private sector ought to have been moving forward 6 or 7 percent; should it not?

Secretary REGAN. Well, it should because world trade, while it has contracted in 1982 because of the worldwide recession, and should improve as we pull out of the recession. There seems to be indication that most of the industrialized nations, particularly here in the United States, are at least at the stage of starting to pull out. Consequently we are going to need the banks even more as international trade picks up.

I do not think that we are going to see a drop in the percentage that we have had of these overseas markets as world recovery occurs. We are going to try to expand our markets. We are bending every effort to make the types of arrangements that will be conducive for exports by United States companies—whether it is service companies, manufacturing companies, or even agricultural companies.

Certainly, without financing that is not going to be possible.

Senator MATHIAS. Do you see any danger or inconsistency in the position that has been developing here in which on the one hand we recognize the need for continued participation by the private sector, even greater participation by the private sector; and on the other hand people say, "Well, the banks just got greedy. They got careless. They went overboard and therefore we are going to have to impose some kind of regulation, some kind of restricting on the commercial banks in their international dealings."

Now, is that kind of talk inhibiting to bank participation?

Secretary REGAN. Well, a lot of it is that way. That type of talk has frightened many bank boards, I think, into suggesting that perhaps all loans should stay at home or things of that nature.

This is wrong, in my judgment, because I do think that a truly good bank should go overseas with its own customers. Most all banks do have customers who are selling abroad. I think they should go with them and not turn that business over to one of the big city banks just because the customer has gone abroad.

Now, from the point of view of all bank loans, I do not think anyone would want to defend every single bank loan that was made to every developing country. Certainly, there have been mistakes made, perhaps overlending.

But at the same time, I think that type of thing can be more closely supervised. I know that Senators Heinz and Proxmire are talking of a bill of this nature, of having closer supervision. We have indicated at Treasury we would be glad to work with the Congress in developing these thoughts so the regulators—the Federal Reserve, the Comptroller of the Currency who reports to me, and the FDIC—will be able to develop more supervision of the types of loans.

But certainly, to suggest that there should be some type of cutoff or that there should be some limit and the like, I do not think is the job of the Federal Government. I think that this is up to the bank to have good practices in line with sound banking.

But from the point of view of supervision of how that is done and how they are adjusted, and when the loans become nonproducing loans and the like, I think that is something that probably could be tightened.

Senator **Mathias**. Mexico got into trouble on very short notice last August. I personally think that the administration reacted in a very positive way and a very constructive way.

As chairman of the economic team you certainly deserve a great deal of credit for having reacted in the right way in getting us through a very sudden, and a very difficult, and a very dangerous crisis. So, you have a good track record. But I do not want to test your capacities here too far.

A number of the witnesses that we have had here have argued that ultimately Mexico and Brazil, and the other countries, will really have to rely on a global recovery, a general economic revival to get out of this problem. That what we are talking about with IMF and with further private-sector lending is simply to get them through the rough time. But the real cure for the problem lies in economic recovery.

Now, suppose—and I am not predicting this but I am just recalling how quickly we got into trouble in Mexico—suppose that recovery is slower than we hope it is going to be. Suppose it is not adequate to pull these developing countries through the rough patch. Have you developed any contingency plans that will deal with that kind of problem?

Because, as Senator Lugar suggested, the increased quota we are talking about now would not be adequate if there is a rough period, a prolonged rough period, still ahead.

Secretary **Regan**. I think that what we would have to do if there were to be such a period—and we are not projecting that—but if there were to be such a period we would have to go for further belt-tightening measures, both domestically and in the international arena.

I think most of the large debtor nations have now approached the IMF. There are still some, perhaps, in the oil exporting countries to come. But by and large the largest of them already have IMF programs.

So, I think that the worst is behind us. There is no doubt that even those with IMF programs, if there were a much longer period of recession in the world than we are currently forecasting, would have additional difficulties that would have to be met in one way or another.

But I think that is the type of thing that on a one-by-one basis we can handle. I think if we get the Mexican loan settled this week and if we get the Brazilian loan settled next week, I think then we have the worst behind us and we can handle where we go from there. Obviously, if we go into another 1933–37 period, well, all bets are off and we would have to start all over again. But I do not see that.

Senator **Mathias**. God forbid that that occurs.

Secretary **Regan**. I do not see that coming, Senator. So, our worst-case scenario is something short of that. I think that even in the worst-case senario the funds that we have now, the $99 billion that will be the new IMF quota subscribed to by its member nations, along with the $19 billion of the general arrangement to borrow, should be able to handle the situation.

If we had not thought so, we would not have argued so strenuously for that position in these recent quota discussions that culminated with the Interim Committee's decision last February 10 and 11.

But we do not see that happening and we think there are sufficient funds in the IMF now to handle most situations.

Senator MATHIAS. I am sorry, my time is up.

The CHAIRMAN. Thank you, Senator Mathias, very much.

Senator Kassebaum?

Senator KASSEBAUM. Thank you, Mr. Chairman.

Mr. Secretary, as has been mentioned and as you certainly are well aware, there is a great deal of concern abroad in the land about, one, the great fear of an international bank collapse; but two, the responsibility that one has with bailing out the banks.

Would it be possible for the commercial banks to lower interest rates or declare a moratorium on interest rates? What responsibility does the IMF have to the commercial banks for its assistance? Would that not help dispel some of the belief that this is a mechanism that would be only an effort to bail out the banks?

Secretary REGAN. Well, in ordinary banking terms the worse the risk, the higher the rate. If you are dealing with a nation that is faced with a difficult problem and if you are going in for debt restructuring—whether this is domestic or international—ordinarily the lender charges more for his money than if the person were a good credit risk to start with.

So, to ask the banks to cut back in order to help out these nations, I think, would be counterproductive because the banks then would not want to make those loans, and there is no way you could drive them to make the loans.

So, I think what you would be doing is actually—and that is chart B that I showed, that we would have even less participation by the banks if they had to do it for less of a fee.

Senator KASSEBAUM. It is very obvious that there have been cases where imprudent decisions have been made by banks as well as the countries that are overextended. And while we all fear what might happen, I think prudent decisions have to be made about the best way.

It seems to me the banks have some responsibility in this.

Secretary REGAN. Well, the banks do have responsibility. One of the things they are finding is that current difficulties are being reflected in their price-earnings ratio.

So, to that extent they are being punished. Those that go too far one way or the other, either domestically or in the international field, suddenly find themselves with the board asking the officers of the bank how come, and then perhaps there being a major reshuffling in the bank. That has happened in several institutions.

So, I think that the banks are participating in this. If you were to listen to bankers, you would find that they think they have participated probably too much in the process.

Senator KASSEBAUM. That is very true, that frequently is the case. But I do not know, that is one thought that occurred to me that might show the willingness of the banks to address some of their own responsibility in this.

Secretary REGAN. Personally, I would rather see the bank lower the rates at home. If they lower the rates at home, internationally rates would come down and that would benefit both those who are getting into IMF programs as well as our domestic economy.

Senator KASSEBAUM. Well, we are all for that. But I was speaking specifically of the overextended loans to those countries such as Brazil or Mexico.

Has there been any thought to some mechanism that the private sector can put together with the banks, and the governments trying to see what other solutions there might be, with the private sector playing a role rather that just looking to the IMF at this particular point?

Secretary REGAN. The banks themselves are in the process of setting up an "early warning system" whereby they can exchange information as far as lending to various countries are concerned.

I think they have all been surprised by the amount of lending to various nations, banks in one country not being aware of what banks in another country were doing, and even banks in the United States not being aware of what all other banks were doing in the way of lending to that particular nation.

Efforts of this nature, I think, of themselves will be healthy.

Senator KASSEBAUM. And is that working now, is that ongoing?

Secretary REGAN. Well, it is in its early development stage. They are having problems. They have to be very careful of antitrust implications here and also other implications of exchanging information about data and so on.

But within those ground rules, they are working toward having an early warning system. We have encouraged them, the Federal Reserve has encouraged them. And I think that the banks of the world will work out this system independently of any government or government agency.

Senator KASSEBAUM. Another question. You showed how our export market had expanded. On the other hand, our trade deficit has grown. I think it was $30 billion in 1982, and it is projected to be a $75 billion deficit for 1983.

I believe you have said, Mr. Secretary, that you thought that we should give some thought on ways to stabilize the international currencies. I wonder if you have implemented those thoughts in any way.

Do you see a Bretton Woods conference of some nature being of some assistance? I do not know how much of this is inflation, but certainly the value of the dollar versus the other currencies is a major factor in that trade deficit.

Secretary REGAN. It is kind of curious that we are having this problem now. You will recall that about 3 or 4 years ago our dollar was too weak and other nations of the world were encouraging us to strengthen our dollar.

We have now strengthened it and everyone is saying, "Weaken it." There must be an equilibrium here somewhere.

Senator KASSEBAUM. Well, it has swung back and forth.

Secretary REGAN. That is true. All international currencies have been swinging quite a bit. Just yesterday, for example, most currencies moved at least 1 percent or more in the course of the day.

These gyrations in exchange rates due to movements of international funds in a freestanding and open market do cause problems in international trade. They also cause problems among international monetary authorities.

What we are trying to do is to see if we cannot get a convergence of economies. That is, if we get all of the nations, industrialized nations, working together to get inflation down, for example, then their interest rates should come down together. As interest rates come down, there will not be these gyrations of the so-called hot money that moves around the world, seeking higher rates of interest in one country rather than in another.

If the United States has the highest rates of interest, money will flow in here. That is what caused our dollar to go up so much during 1981 and 1982, our high rates of interest.

If, on the other hand, our rates of interest come down, the dollar should weaken.

Senator KASSEBAUM. But our interest rates have not really come down in proportion to the inflation rate.

Secretary REGAN. No; not as yet. No, the real rate of interest has stayed much higher than normal.

The summit nations also have a study underway to see if intervention, intervening in the currencies, is good, bad, or indifferent.

Those studies are now at the discussion stage. The papers have been written. The deputy finance ministers will be reviewing and discussing them soon and the finance ministers will be discussing them in late April when they meet here in Washington, to see whether or not intervention will work. Some say it will, some say it will not. I remain skeptical and I want to see the results of these studies before we just throw dollars at the problem.

But I do think that on balance—in answer to your question—there is a need for more stability among currencies, particularly the leading currencies of the world. Were that to occur, you would see less gyrations and international money would flow in a better fashion.

Senator KASSEBAUM. But you believe at this point in time it is larely getting inflation under control around the world?

Secretary REGAN. It is primarily interest rates. It is money seeking the highest rate of interest. At the present moment, some of the highest real rates of interest are still here in the United States, and that is why we still have that strong dollar. If interest rates go down, money will leave the United States, seeking higher rates of interest and stronger currencies.

We also have, by the way, among the strongest, if not the strongest currency currently, from the point of view of stability.

Whenever there is an upset in the world, such as we have had in the last couple of weeks over oil prices, there is naturally a flight to quality. The quality is the dollar, and that is why in recent weeks the dollar has remained strong.

Senator KASSEBAUM. How much does the price of gold have to do with the psychological effect on the money?

Secretary REGAN. Psychologically, quite a bit. It was said that as interest rates went down in the United States, the price of gold was going up. But yesterday, the price of gold fell dramatically at a time when our interest rates came cown. But that was due, they tell me now, to the fact that those who trade in gold think that we are going to have much less inflation in the United States and therefore gold is not needed as a hedge. That is why the price came down yesterday.

There is no pat answer to your question.

Senator KASSEBAUM. You wish you had a crystal ball?

Secretary REGAN. Several of them.

Senator KASSEBAUM. Thank you very much, Mr. Chairman.

The CHAIRMAN. Senator Boschwitz?

Senator BOSCHWITZ. I always enjoyed, Mr. Secretary, reading the day after why those things happened. Unfortunately, they are seldom written the day before and they really cannot be.

You said it would be a good thing if some of the leading countries stabilized their currencies in relationship to one another. How would you suggest that be done?

Secretary REGAN. That is the key question. That is what we are trying to think through now as part of these convergence studies that we are making and part of the intervention studies.

Some say that if we all had more or less the same rate of inflation and we all had more or less the same rate of interest, our currencies would probably stay in balance, unless one nation were able to export a lot more. The difference in the current account might change the relationship but only slightly.

Others say that intervening can bring about exchange rate stability. They give as an example the European monetary system where intervention there seems to keep currencies more or less in line.

I am not one of those that believes that massive intervention, going against the tide, can stop the market. I think we need to think it through a little bit more.

Senator BOSCHWITZ. I quite agree. I'm skeptical of the premise that inflation rates are the same among the leading trading nations, or the leading economic nations, the basic rate of inflation is often very differenct among those nations.

Let me go on to the IMF and some of the other regional banks. I am not sure that questions have been directed at them. The total lending of the IMF, it is not a large factor in the whole. It is not a large factor in the total lending to the various nations; is that a correct statement?

Secretary REGAN. The IMF?

Senator BOSCHWITZ. That is correct.

Secretary REGAN. No, it is not a large factor; no.

Senator BOSCHWITZ. For every dollar that the IMF lends, the commercial banks lend?

Secretary REGAN. $4 to $5.

Senator BOSCHWITZ. The total capitalization of the IMF is $66 billion. The loans to the lesser developed nations are quoted now in the $600 to $700 billion range. I would almost think it is 10 to 1.

Secretary REGAN. From that angle. I was thinking more in the longer term. But that includes all types of trade financing, you are right.

Senator BOSCHWITZ. The IMF really sets the path by establishing some conditions on the borrowing nations and which entice the banking system to go into those nations, feeling things will be OK and the risk is better. That is also a fair statement to make, is it not?

Secretary REGAN. Yes. But the IMF only goes in after the nation is in trouble.

Senator BOSCHWITZ. I understand.

Secretary REGAN. Most of the banks go in a lot sooner than the IMF.

Senator BOSCHWITZ. That, of course, is part of the problem; they helped create part of the problem, and as a result now the feeling is abroad, as Senator Kassebaum said, that we have to bail out the banks. However, as Senator Mathias pointed out, we are in a sense "bailing them in" rather than bailing them out. The IMF just establishes the path, it is not a large lender itself.

Our share of the IMF is about 20 percent; is that correct?

Secretary REGAN. To be precise, after this new quota we will have 19.9 percent of quotas and 19.1 percent of the vote.

Senator BOSCHWITZ. And are the other nations anteing up their share on schedule?

Secretary REGAN. Oh, yes. As a matter of fact, most of the industrial nations wanted to go further than we did. They will not have trouble with their parliaments as we will have with our Congress—if you do not mind my saying so—because most of the Finance Ministers are already members of parliament and once they submit a budget it is passed; they do not have to go any further.

Senator BOSCHWITZ. Are you suggesting you want to run——

Secretary REGAN. No; I am merely pointing it out for the record, Senator. [Laugther.]

Senator BOSCHWITZ. I noticed in the multilateral development banks that we stage our payments. So, my question is, can that not be done perhaps with the IMF? Can the payments perhaps be staged?

Secretary REGAN. They will be staged. Once the quota is approved it is never drawn down 100 percent at one time. It is not paid over in 1 year by the nation that is called upon to put up its money.

We ordinarily put up at most 25 percent in cash, the rest on a letter of credit. When the letter of credit is drawn down—and it has been running about half a billion dollars a year up until 1980 and then in 1981 and 1982 it jumped to a little over $1 billion per year—we receive an SDR denominated reserve asset in the IMF which earns interest. So, we have an asset to replenish the liability that we have created.

Senator BOSCHWITZ. I understand.

Secretary REGAN. And it is drawn out—in answer to your question—it will be drawn out over a period of years, the take-down.

Senator BOSCHWITZ. The fact that we have a corresponding or returning asset for what is put in as budget authority, not outlays, I realize is not well understood.

But in the past when we have been asked to come up with a budget authority figure to replenish or to expand the IMF capital base, over what period of time has it been drawn upon?

Secretary REGAN. For the first 30 or 35 years of bank history it was an every-5-year replenishment. But the 1976 replenishment that was voted in 1978 was followed by another one in 1980. And now we have another one in 1983. In the last 5, 7 years, they have come very rapidly.

Senator BOSCHWITZ. So, therefore they must be drawn down more quickly in recent years. How quickly do you expect this $7.8 billion or approximately $8 billion—it is all budget authority, I believe—how quickly do you expect that to be drawn down?

Secretary REGAN. If we are going to split it into two piles, the first portion being the $5.8 billion quota increase and the other the $2.7 billion General Arrangement to Borrow, the latter one, the General Arrangement to Borrow, I do not anticipate will be drawn down. It would surprise me if it were drawn down at all, or more than once or twice over the 5-year period.

The remainder, the $5.8 billion, I anticipate under current conditions—and of course as I speculated with Senator Mathias, worse things can happen—but under normal conditions I would expect that we certainly should be able to get through the 5-year period.

Senator BOSCHWITZ. So that you think it will be staged in relatively slowly?

Secretary REGAN. Yes: $5.8 billion over a 5-year period.

Senator BOSCHWITZ. Since the IMF is not really the principal lender but is more of a guidepost that establishes the conditions under which loans will be made and these conditions have to be imposed by the government upon its country, why in that case can this not be done by guarantees? Why can we not say that the IMF can establish those conditions which will lead to the bank lending that you point out, and why can those conditions not be established without making the loans?

Secretary REGAN. In the first place, the banks want to see other money in there besides their own. It gives them reassurance, even though proportionately it is much smaller than they have in a particular country.

Nevertheless, the fact that the IMF—the 146 member nations—has put their money into that country is very reassuring to commerical bankers that they should be able to follow that.

Senator BOSCHWITZ. But yet, most of our constituents feel that commercial bankers have been at least a part of the problem and for us to now give them reassurance for a problem that they have had a hand in creating, there is a certain lack of equity in that.

So, why cannot the IMF establish the conditions under which it would make a loan and either make a smaller loan or make no loan at all? And having once set the conditions that thereby the other banks would be enticed to enter in.

Are you suggesting the banks have to see the IMF put some of its own money on the line. I presume there are some renewals with respect to the IMF former loans—why cannot the IMF just deal then with the renewals?

When the renewals come up, establish the conditions for giving the renewals and then the banks will say, "Well, they have their money in there and we can now make the loans." And the banks, of course, have a self-interest in making those loans anyway because they do not want a default any more than any of us want a default.

I ask these questions because, as you point out, the other countries who will be contributing to the IMF have Finance Ministers who are members of their Parliaments. That means getting IMF quotas passed in their legislatures might be a little easier. That is not the case in our society and there may be some problem.

Secretary REGAN. I think my answer goes along this line, Senator, that the political process requires the input of actual cash by the IMF because the country is being asked to undertake quite a program in order to get something. That something is the IMF money itself. Why else do they go in for these stringencies? They have to cut back.

Senator BOSCHWITZ. The banks will come in if the IMF will.

Secretary REGAN. But in some cases additional bank financing is not needed, it is just IMF funds when you have a small program. We have focused on the larger problem nations, the Mexico, Argentina, the Brazil type of problem. But there are many smaller programs where the sums that are put up by the IMF are sufficient to cover that particular program. They do not need the addition of the commercial bank money, or additional commercial bank money.

Now, what I am saying, is that for the citizens of that country to undertake the problem there has to be some "quid" for the "quo." And the IMF is saying, "If you do this, we will lend you money."

Now, if it were just to be, "If you do this, we will see that the banks of the world do this," they could not guarantee it. So, they are guaranteeing it by putting up money from this fund. That was what the fund was created for.

Senator BOSCHWITZ. I understand that. I see my time is up.

But inasmuch as the $5.8 billion that is going to be drawn down over a period of years, it is possible for us to authorize less and authorize some in each year?

Secretary REGAN. I think that what would happen then, you have every other nation in the world doing the same thing. Therefore, the IMF instead of being able to plan its cost over a period of years when dealing with nations would be a very short leash—too short for international purposes.

I think that what you are doing actually is saying, "Here is a line of credit" and you draw down on that over a period of years. If you look at it from that point of view, that is all you are authorizing is a line of credit. And then we, at Treasury, utilize that as the requests come in from the IMF.

Senator BOSCHWITZ. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Boschwitz, very much.

Just to be sure that the record is straight on that colloquy, is it not true that U.S. payments to the IMF can be staged, but appropriations cannot? In other words, appropriations cannot be stretched out.

Secretary REGAN. Yes; that is true, Senator.

Senator BOSCHWITZ. Well, one second, I did not understand that question and answer.

Well, it is staged in because they draw down slowly. But the initial budget authority has to be given all at once. Is that it?

Secretary REGAN. That is the point. We get the budget authority to do this and then we can stage in. If we did not have the budget authority to do this each year as it came up, we would have to come back for a new budget authority. There would be no guarantee and therefore the IMF would not know just what the contribution of the United States was going to be.

Senator BOSCHWITZ. I understand.

The CHAIRMAN. Fine, thank you. Senator Murkowski?

Senator MURKOWSKI. Thank you, Mr. Chairman.

Mr. Secretary, in your testimony you made reference to the fact that the United States has used the IMF from time to time. I assume such use was to expand our exports and basically contribute to the world economy.

Could you enlighten me a little more on specifically what the use of the United States has been?

Secretary REGAN. If I can find my reference.

Senator, let me go over this with you. We first started drawing from the IMF in 1964. And reading here from my notes on this, during the 1950's and 1960's we had substantial losses of gold and foreign accumulations of dollar holdings.

That put strains on our system. We had large payment imbalance. So, we borrowed or drew down the reserve we had at the IMF in order to replenish——

Senator MURKOWSKI. And free up liquidity and so forth.

Secretary REGAN [continuing]. What we were losing in the United States. In the early 1970's we ended the gold convertibility arrangement. We then used the IMF drawdown to intervene in the currency markets to stabilize the dollar.

In November of 1978, which was the last time that we drew it down, we drew down $3 billion in German marks and Japanese yen and used those to protect the dollar and try to strengthen the dollar when it was declining in those years.

Senator MURKOWSKI. We are certainly not doing that at the current time.

Secretary REGAN. We are not doing it.

Senator MURKOWSKI. We have a strong dollar. What are we doing currently with our participation in IMF?

Secretary REGAN. We keep it there just as a reserve asset.

Senator MURKOWSKI. As a reserve. So, our participation would be substantially different than a developing nation's.

Secretary REGAN. Yes.

Senator MURKOWSKI. Now, I am wondering if you have any figures, Mr. Secretary, to indicate how much of a particular allotment to a given Third World country is usually used specifically to service existing debt?

Secretary REGAN. Their allotment in the IMF?

Senator MURKOWSKI. Yes.

Secretary REGAN. I do not have that.

Senator MURKOWSKI. Can you give us any figures relative to the total amount of IMF that is outstanding now to service debt, specifically?

Secretary REGAN. We do not have that in totals. We would have to go on a country-by-country basis, but we will try to look it up and submit it for the record.

Senator MURKOWSKI. Can you give us a percentage of a country's total? For example Mexico, that might be utilized specifically to service debt. And I am speaking of taking the debt that is outstanding, that is due, rewriting it, bringing it current, and taking the interest into income by the participating bank, the private bank that is a participant.

Secretary REGAN. Well, we know that Mexico's external debt is $80 billion. Now, what other figure do you want on top of that?

Senator MURKOWSKI. I want to know how much of the allotment to Mexico by the IMF is being used to service debt. In other words, the implication being that to bring the debt current, the bank would rewrite the debt, take the interest into income and the interest, of course, would come from IMF.

Secretary REGAN. No; the interest would not come except to the extent that money is fungible. What would happen here with whatever money that Mexico would receive from the IMF, a portion of that would go to pay off their trade balance.

Senator MURKOWSKI. Maintain liquidity, I understand that.

Secretary REGAN. Maintain liquidity. So, they would be paying for goods received with part of that money. It would not all be spent just on interest on the debt.

Senator MURKOWSKI. Well, I think it appropriate, Mr. Secretary, to have some idea for the record of how much of the allocation is specifically for the servicing of debt.

Secretary REGAN. Well, we are trying to come up with how much Third World debt is, rather total debt of all nations who are members.

Senator MURKOWSKI. Yes; that is part of it.

Secretary REGAN. You see, here is my problem, this is why I cannot get quite through my head exactly what it is I should be looking for because the United States has $1 trillion worth of debt. We are also going to put up $5.8 billion. None of that is going to be to service our debt.

Senator MURKOWSKI. That is right. When the interest is figured, it is added onto the $1 trillion and our debt increases.

Secretary REGAN. Only our borrowings. The interest we would receive when we put up money at the IMF. We are not borrowing, we are lending money to the IMF. We get interest back on that.

Senator MURKOWSKI. Right.

Secretary REGAN. That is a receipt to the United States. That becomes part of our budget receipts.

Senator MURKOWSKI. But we are both aware and concerned with the tremendous growth of debt. And I am suggesting—I think you would acknowledge—that that also includes interest on interest.

Secretary REGAN. Yes.

Senator MURKOWSKI. And my question is specifically, how much of the total allocation of the IMF is directed toward debt retirement, or went into debt retirement?

I think that is a concern that has been expressed.

Secretary REGAN. I will try to come up with that for the record. But you understand that in the case of Mexico, or indeed Brazil or some of those other countries, there will be no paydown of debt this year. They do not forecast any payback.

Senator MURKOWSKI. There will be a payback of interest.

Secretary REGAN. They will be paying interest to the IMF and also to the commercial banks.

Senator MURKOWSKI. But I am talking about the funds that the IMF makes available to that country. Is that used as interest to bring current the outstanding portion of the private sector's past due loans?

Secretary REGAN. I would say, only to the extent that money is fungible. I mean, you could not trace it that way, how they well use the money when it comes in.

I see the point you are trying to make now and I will try to be responsive to it because I do not have that in my memory or at my fingertips here, to try to equate the amount of interest on interest that Mexico will be paying, compare that with the amount of loans they will receive from the IMF.

Senator MURKOWSKI. Because it is the contention, I think, of the entire committee that the idea of the International Monetary Fund is to expand the export base, the economic base, the job base, and so forth.

But if in reality there is a significant percentage of IMF funds just going in for existing debt reduction or to bring interest current, then I think we have to look realistically at what we are doing.

I very frankly would appreciate that information for the record because I think it is pertinent to what we are deliberating.

Secretary REGAN. We will try to be responsive to that, Senator.

[The information referred to follows:]

IMF FINANCING AND LDC DEBT SERVICE

It is impossible to indicate the amounts of IMF financing that might be used to finance payments of principal or interest in borrowing countries. The financing provided by the IMF is general balance of payments financing. It is not earmarked for particular expenditures, and can be used to finance any of the wide variety of international payments that countries make. The attached table on the U.S. balance of payments suggests the multitude of transactions that enter countries' balance of payments accounts. Given the fungibility of money, including disbursements of IMF financing, it is neither possible nor meaningful to say that this dollar is to be used for one particular transaction and that dollar for another.

However, the following figures suggest the scale of IMF financing in comparison to some major types of LDC external payments. In 1982, net IMF disbursements to non-OPEC developing countries amounted to about $8 billion. Total imports by these countries amounted to some $400 billion, and their debt service payments, including both principal and interest, amounted to an estimated $95-$100 billion. With respect to Argentina, Brazil and Mexico, three of the major borrowers that have recently entered IMF programs, total IMF disbursements in 1983 are expected to be equivalent to about $6 billion. Nearly all of the principal of commercial bank financing coming due in 1983 is expected to be rolled over or refinanced, and net new bank financing is projected at nearly $11 billion. Net foreign interest payments of these countries are projected at about $24 billion during 1983, while their total imports are projected at about $37 billion.

Table 1-2.—U.S. International Transactions

[Millions of dollars]

(Credits +; debits −)	Line	1981	Not seasonally adjusted						Seasonally adjusted					
			1981			1982			1981			1982		
			II	III	IV	I	II r	III p	II	III	IV	I	II r	III p
Exports of goods and services	1	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Merchandise, adjusted, excluding military	2	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Transfers under U.S. military agency sales contracts	3	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Travel	4	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Passenger fares	5	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other transportation	6	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Fees and royalties from affiliated foreigners	7	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Fees and royalties from unaffiliated foreigners	8	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other private services	9	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
U.S. Government miscellaneous services	10	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Receipts of income on U.S. assets abroad														
Direct investment	11	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Interest, dividends, and earnings of unincorporated affiliates	12	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Reinvested earnings of incorporated affiliates	13	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other private receipts	14	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
U.S. Government receipts	15	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Transfers of goods and services under U.S. military grant programs, net	16	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Imports of goods and services	17	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Merchandise, adjusted, excluding military	18	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Direct defense expenditures	19	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Travel	20	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Passenger fares	21	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other transportation	22	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Fees and royalties to affiliated foreigners	23	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Fees and royalties to unaffiliated foreigners	24	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Private payments for other services	25	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
U.S. Government payments for miscellaneous services	26	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Payments of income on foreign assets in the United States														
Direct investment	27	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Interest, dividends, and earnings of unincorporated affiliates	28	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Reinvested earnings of incorporated affiliates	29	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other private payments	30	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
U.S. Government payments	31	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
U.S. military grants of goods and services, net	32	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Unilateral transfers (excluding military grants of goods and services), net	33	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
U.S. Government grants (excluding military grants of goods and services)	34	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
U.S. Government pensions and other transfers	35	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Private remittances and other transfers	36	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
U.S. assets abroad, net (increase/capital outflow (−))	37	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
U.S. official reserve assets, net	38	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Gold	39	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Special drawing rights	40	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Reserve position in the International Monetary Fund	41	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Foreign currencies	42	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
U.S. Government assets, other than official reserve assets, net	43	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
U.S. loans and other long-term assets	44	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Repayments on U.S. loans	45	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
U.S. foreign currency holdings and U.S. short-term assets, net	46	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
U.S. private assets, net	47	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Direct investment	48	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Equity and intercompany accounts	49	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Reinvested earnings of incorporated affiliates	50	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Foreign securities	51	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
U.S. claims on unaffiliated foreigners reported by U.S. nonbanking concerns														
Long-term	52	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Short-term	53													
U.S. claims reported by U.S. banks, not included elsewhere														
Long-term	54	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Short-term	55	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Foreign assets in the United States, net (increase/capital inflow (+))	56	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Foreign official assets in the United States, net	57	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
U.S. Government securities	58	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
U.S. Treasury securities	59	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other	60	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other U.S. Government liabilities	61	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
U.S. liabilities reported by U.S. banks, not included elsewhere	62	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other foreign official assets	63	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other foreign assets in the United States, net	64	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Direct investment	65	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Equity and intercompany accounts	66	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Reinvested earnings of incorporated affiliates	67	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
U.S. Treasury securities	68	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
U.S. securities other than U.S. Treasury securities	69	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
U.S. liabilities to unaffiliated foreigners reported by U.S. nonbanking concerns														
Long-term	70	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Short-term	71													
U.S. liabilities reported by U.S. banks, not included elsewhere														
Long-term	72	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Short-term	73													
Allocations of special drawing rights	74	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Statistical discrepancy (sum of above items with sign reversed)	75	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Of which seasonal adjustment discrepancy	75a								[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Memoranda:														
Balance on merchandise trade (lines 2 and 18)	76	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Balance on goods and services (lines 1 and 17)	77	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Balance on goods, services, and remittances (lines 77, 35, and 36)	78	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Balance on current account (lines 77 and 33)	79	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Transactions in U.S. official reserve assets and in foreign official assets in the United States:														
Increase (−) in U.S. official reserve assets, net (line 38)	80	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Increase (+) in foreign official assets in the United States (line 57 less line 61)	81	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

See footnotes on page 53.

Senator MURKOWSKI. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

We have just, I think, a few more questions so we can adjourn in just a few minutes. There is an indication from other Senators that could not be with us today that they wish to submit questions for the record. So, we would appreciate those being answered.

Secretary REGAN. Will do.

The CHAIRMAN. I would like to get your feeling as to whether or not steps should be taken to assure that private banks are paying part of the price associated with the IMF so-called bail out of problem countries.

Secretary REGAN. They will be associated with it, is that what you are saying?

The CHAIRMAN. Yes.

Secretary REGAN. Oh, yes.

The CHAIRMAN. In other words, what steps are taken to assure that they are sharing some of this burden?

Secretary REGAN. Well, there is no way that the IMF is going to let commercial banks out of their loans when they put money in. The Managing Director, as a matter of fact, is on record as stressing that to the bankers of the world. He has called these bankers into the IMF and has lectured them very severely on the fact that they must not pull out and cannot pull out once an IMF program starts.

They have agreed to stay in. So, I can assure you that they will not be pulling out.

The CHAIRMAN. We do have some apparent inconsistency in two different goals. One would be to get commercial banks to lend more at the present time to financially troubled countries, and on the other there are efforts to better manage and limit commercial lending to foreign borrowers.

Can you respond to that apparent inconsistency and how we intend to handle it?

Secretary REGAN. Well, in a certain few cases—and these are particularly among the larger borrowing nations—additional sums are needed because of the current economic condition of the country and indeed of the world.

I think we can give examples there in Mexico and Brazil where they do need additional funds to tide them over until such time as they get back to where they were, which is having a trade surplus.

Brazil had a remarkable trade surplus for many years. It does not have that same surplus now. Mexico, the same thing. But these, we believe, are temporary situations—a year or two—and those nations will again be back in a reasonably good condition.

So, to that extent the banks have to stay with them. To let them go now would be self-defeating for the banks and for the IMF. So, we are encouraging the banks to put additional sums into those countries. But they certainly do not have to put additional sums into every country, nor do they have to go pressing loans at this particular time. Their own banking caution at this moment restrains them, as well as economic conditions.

The CHAIRMAN. I want to say before I ask the next question that you are personally very highly regarded by my colleagues on both sides of the aisle. I think it will make a difference. Your appearance here today and your testimony will go a long way toward helping the administration's position on this supplemental request.

But at the time the administration was seeking a $245 million supplemental request for the World Bank's IDA VI replenishment, when a $100 million increase was considered on the Senate floor last December, we just did not have the feeling that there was strong enough administration support. The signals were not strong back to the Senate at that particular time.

What could you indicate the strength of the commitment that there will be when this is considered on the floor because "shaky" Senators—feeling that this is not going to fly very well at home—if they do not see a real commitment there might just walk away from it.

Senator MATHIAS. I object, Mr. Chairman, there are no "shaky" Senators. [Laughter.]

Undecided maybe, but not shaky. [Laughter.]

Secretary REGAN. Senator, I regret that the Senate got a feeling that the administration was not wholeheartedly behind that commitment for IDA. We definitely want the commitment for IDA—not only this year but for next year also. It is in the 1984 budget.

The CHAIRMAN. Maybe we just did not get the signals.

Secretary REGAN. We will try to make sure that you get the proper signals this time when that does approach a vote because this has been something that has been very troubling to us in the international arena.

This agreement was negotiated by the previous administration. Our administration agreed to go along with it since it was internationally negotiated. As a result, we have fought for it.

But now that there has come the stretchout and it is now over a 4-year period rather than a 3-year period, it has caused quite a bit of dislocation in the World Bank's plans, in the plans of other nations who say, "Well, if the United States can pay over 4 years, why can't we pay over 4 years?

And as a result, the nations of the world—and only the poorest nations of the world literally get the use the soft-loan window, the IDA—are in a turmoil. They are in the middle of a recession, conditions are worse than ever, and they do not see the same amount of funds coming from what they think are the real "have" nations of the world, led by the United States.

So, I think that most anyone thinking this through from a humanitarian point of view would agree that the United States can and should live up to these obligations.

The CHAIRMAN. Fine.

The administration will be transmitting a request to the Congress for the replenishment of the ordinary capital account and funds for the special operations of the Inter-American Development Bank, as well as to create a new institution, the International Investment Corporation under the unbrella of IDB.

What function would such a new International Investment Corporation perform that is not already being done by the International Finance Corporation, which is an affiliate of the World Bank?

Secretary REGAN. Well, what we are trying to do is to have an institution similar to the IFC in the Inter-American Development

Bank, where the private sector would go along with the bank itself in investing in Latin American nations.

We think that this is the wave of the future. With 10 or 25 percent put in by the IDB, and the rest put in by the private sector, you are able to leverage the amount of money that is available to these nations for development.

The private sector has indicated to us that if an international banking agency is going along with a loan of this nature, they would be more willing to join than try to do it by themselves for these longer term projects.

So, we have tried to encourage this. We think the more that they can get the private sector involved, the less government aid and assistance will have to be forthcoming. We think that is the proper way to do it.

The CHAIRMAN. Thank you very much.

Senator Mathias?

Senator MATHIAS. Very briefly, Mr. Chairman. The Secretary has outlined a program in which the primary focus is on the IMF and which we have agreed will require the continued participation of the private banks.

But there will also have to be other action. You have mentioned IDA several times during the course of your testimony.

That brings to mind the latest report of the Brandt Commission which refers to some increased lending capacity for IDA. They also talk about continuation of the practice of providing "bridging" loans by the Bank of International Settlements. They talk about additional allocations of SDR's to be distributed on the basis of need by the IMF.

In other words, the brandt Commission looks toward a coordinated strategy across the whole international financial establishment dealing with this serious problem.

I wonder if you would comment generally on those features of the plan which are beyond the IMF quota increase that is our primary subject here.

Secretary REGAN. Senator, maybe I could use an analogy here. If you are trying to pull something heavy out of a pit, the more ropes you can get around it and the more people you can get on the end of those ropes, the better off you are pulling that out of the pit.

When you are trying to help developing nations, the more things that you can bring to bear on the problem, the better off you are. There are soft-loan windows; there are hard-loan windows; there is the IMF in the monetary field; there are the commercial banks and there is direct bilateral assistance from the industrialized nations to these developing countries.

All of this has to be pulled together. I would not think that there should be any kind of a "super" agency that is allocating all of this, but I think that the existing agencies themselves can and should learn to work together in a better fashion.

I think too often in the past one agency has gone off one way and one another, without coordination. I think a lot more of that can be done by interaction among the agencies.

That is what we have been encouraging in our discussions with other Finance Ministers, that the thing be better coordinated.

I think that when emergencies arise then you have to work fast and in different ways. But under the ordinary circumstances, it would seem to me that with all of these agencies and amounts available, it would be desirable for the Finance Ministers of the world to coordinate these actions and they are striving to get better coordination among themselves in order to utilize all of these agencies better.

Senator MATHIAS. I suppose what I am really fishing for is your assurance that the administration is not putting all of its eggs in the IMF basket.

Secretary REGAN. Far from it.

Senator MATHIAS. You are prepared to use all these other instrumentalities in coordination with other nations.

Secretary REGAN. As you know, the Secretary of State has been up here for foreign aid and the like. Regarding, the multilateral development banks, we at Treasury, are working very closely with State in furthering the aims of those institutions and in furthering the amount of money that is available from the United States.

We are asking for large handouts here. We recognize the stringencies of budget. That is why we have fought so hard in these agencies to keep down the amount of the request, trying to be sensible about what the Congress can and should allot to these agencies.

I think we have developed a worthwhile and sensible program—and it is one that the administration is fully committed to—involving bilateral and, multilateral development agencies and also the International Monetary Fund.

Senator MATHIAS. Among the witnesses that have appeared in this series of hearings there has been a consensus in support of the proposition that you have laid before us today, of a need to increase quotas.

But one subject upon which there has not been consensus—and I am wondering if you would mind just speculating with us for a moment—is on the subject of stabilization of currency exchange rate.

Some of the witnesses have talked about the need for a system that would at least prevent the far end of the swing. They do not think you can regulate day-to-day fluctuations of currency exchange rates, but that the extreme swings ought to be restrained.

They have recommended that something like the European "snake" be created, at least for the leading currencies of the world.

Do you have any thoughts on the subject?

Secretary REGAN. Well, we are studying the problem. It has no simple solution, it has no pat solution. Once we left gold and stopped tying ourselves to that, we have created this free market that does move.

There is no doubt, also, that the coming of the electronic age has added a new dimension to this problem, that money can be transferred rapidly around the world. Trading takes place in currencies now 24 hours a day, and in huge sums—so much so that to try at this point to stop some of this or to interfere in the process gets to be practically impossible.

There are many who say that the proper way to do it—and I am one of those—is to have the nations of the world with low rates of inflation, with most of the nations of the world at or near full employment. If those conditions exist, then the currencies of the world will more or less stay within a narrow fluctuating band, depending upon supply and demand.

But if one nation gets out of whack and it inflates its economy when everyone else is deflated, there is bound to be a weakening of that currency against the other currencies. And I do not think anything can stop it except by a change in policy.

So, you have to bring in not just monetary people but also political people who have the desires and the will to do certain things within their own country.

So, it cannot be left just to monetary authorities to try to straighten out these problems. I think a political structure has also got to be brought in. That is why I think that these summits, for example, are worthwhile—even though they may not produce great news. At least the leaders of the world get to understand each other and what they are trying to do with their own economies.

The drive toward protectionism, this interferes with what is happening in the world's currencies.

So, I think that all in all the world is learning a lesson as we emerge from this recession, which is that low inflation and sound fiscal policies are probably as important as anything else to the stability of the world.

Senator MATHIAS. Thank you very much, Mr. Secretary. I think your testimony has been extremely helpful. You have struck a very good balance between urgent need and dangerous crisis. I think that is an important contribution to these hearings.

Secretary REGAN. Thank you, Senator.

The CHAIRMAN. I agree, it has been very important.

Just from a procedural standpoint, when can we expect the legislation to be sent up here?

Secretary REGAN. We should have it ready within a matter of days, Senator.

The CHAIRMAN. We will put it on as fast a track as we possibly can here. There will be concurrent reference, of course, referral to the Banking Committee. We work closely with them.

There may be one possible amendment either committee might want to add to it. But we will move it just as rapidly as we can. This is an excellent time to try to move it forward on the floor, too. We do have time now, where later we get jammed up.

Secretary REGAN. Senator, we stand ready at Treasury, and I personally am ready at any time to meet with anyone that could help in keeping this on a fast track.

The CHAIRMAN. We appreciate that very much.

If there is no further business. The meeting is adjourned.

[Additional questions and answers follow:]

TREASURY DEPARTMENT'S RESPONSES TO ADDITIONAL QUESTIONS SUBMITTED FOR THE RECORD

Question 1. Recalling that at the time of Mr. Casanova's confirmation hearing an issue was raised concerning U.S. policy with respect to internal personnel matters of the IDB—specifically, with respect to recommending termination of Bank personnel for political reasons. At that time, Mr. Casanova told the Committee, in writing, that this was not the policy of the United States. Additionally, he pledged that no major personnel initiatives would be undertaken without consultation with members of the Committee.

Does Mr. Casanova continue to stand by the pledges?

Does this continue to be the policy of the United States?

Despite these pledges, has Mr. Casanova been making representations to the President of the IDB indicating that the United States wants certain individuals on the staff of the Bank terminated because their political philosophy may not be in keeping with his own?

Does the U.S. Executive Director speak for the Administration on questions of the removal of personnel from the IDB? If not, has this been made clear to both the U.S. Executive Director and the President of the IDB?

Answer. I want to reaffirm that the U.S. Government does not judge the performance of employees of the international institutions on the basis of an employee's political philosophy. Nor does the U.S. Government recommend employment or termination of employment on such a basis. Mr. Casanova, as U.S. Executive Director, adheres to this policy and reaffirms the commitments made to the Committee on the matter at the time of his confirmation.

I also want to affirm that prior to taking any major personnel initiatives in the institution, the Committee will be consulted.

As Executive Director of the IDB, Mr. Casanova effectively wears two hats. He is a representative of the United States, as well as a senior executive of the institution. In the latter capacity, he is expected to encourage the highest standards of professional efficiency and competence in the IDB staff. The United States does not advocate the termination of individuals on the staff of the Bank because of their political philosophy or activity. Mr. Casanova is aware of, and supports this position which is consistent with the pledges he made at the time of his confirmation.

Question 2. Why did the United States prefer the 47 percent quota increase plus a $12 billion increase in the General Arrangements to Borrow (GAB) by a select group of industrial countries including the United States rather than a larger increase in quotas? Wouldn't there have been more equitable burdensharing by all members had a larger quota increase been agreed to? Was there any attempt to include Saudi Arabia in the GAB expansion? Why not?

Answer. The principal objective of quota reviews is to ensure that the IMF will have sufficient resources to meet official balance of payments financing needs that can reasonably be expected to arise over the medium-term. Given rapid shifts in world payments patterns and uncertainties regarding the demand for IMF resources over the medium-term, assessments of the "appropriate" size of IMF quotas have traditionally focused on broad economic aggregates and qualitative judgments. Trends in world imports are frequently used as a proxy for changes in world economic activity and assessing the size of IMF quotas in relation to global economic aggregates. The trend of IMF quotas as a percent of world imports has been generally downward, from a high point of about 13.6 percent in 1950 to approximately 4 percent at present. Such comparisons offer no reliable guide to the "appropriate" size of IMF quotas, since they do not take account of the enormous expansion of other sources or potential sources of financing that has taken place over the years and do not provide a clear indication of the scale of demands for official balance of payments financing that might arise in the future. They do, however, suggest the major reduction of the IMF's size relative to international transactions that has occurred over the past three decades.

At the outset of the quota discussions in early 1981, many IMF member countries favored a doubling or trebling of quotas, arguing variously that:

Balance of payments financing needs, particularly on the part of developing countries, could be expected to remain large during the 1980's;

The size of the IMF relative to levels of world trade and economic activity had fallen substantially over the years, and this trend should be reversed; and

A very large quota increase would be needed to enable the IMF to play a growing intermediary role at a time when large payments imbalances were expected to persist but private markets might be curtailing lending.

While agreeing that quotas should be adequate to meet needs for temporary balance of payments financing, and that this implies some quota expansion with growth in the scale of the world economy and international payments, the United States was concerned that proposals for a doubling or more of quotas were excessive and that such a large increase would not be the most efficient way to equip the IMF to deal with unpredictable and potentially major balance of payments financing problems that could threaten the stability of the system as a whole.

Accordingly, the United States proposed a dual approach to strengthening the IMF's resources:

(a) A quota increase which, while more modest than sought by many, could reasonably be expected to enable the IMF to meet demands on its resources in normal circumstances; and

(b) Establishment of contingency borrowing arrangements, supported by major creditor countries most likely to be in a position to provide financing when needed, that would be available to the IMF on a standby basis in case of need to deal with balance of payments financing problems on the part of any member that threaten the international monetary system as a whole. The United States felt that such borrowing arrangements would have important attractions.

Since credit lines would be established primarily with countries with relatively strong reserve and balance of payments positions, they could be expected to provide a greater proportion of usable resources than a quota increase of similar size. Consequently, such credit lines would be a more effective and efficient means of strengthening the IMF's ability to deal with extraordinary financial difficulties than a comparable increase in quotas.

Second, since such contingency credit lines would not be drawn upon in normal circumstances, this source of financing would be conserved for emergency situations. By demonstrating that the IMF is positioned to deal with severe systemic threats, such borrowing arrangements could provide the confidence to the private markets that is needed to ensure that capital continues to flow, thus reducing the risk that problems of one country would affect others.

Finally, creditors under the arrangement would have to concur in decisions on its activation, ensuring that it would be used only in cases of systemic need and in support of effective adjustment efforts by borrowing countries.

Subsequent discussions in the IMF Executive Board and other forums indicated very considerable interest in this concept and, specifically, in adapting and expanding the IMF's existing General Arrangements to Borrow (GAB) for this purpose. The GAB is an arrangement established in 1962, under which the ten major industrial country members of the IMF—the "Group of Ten" or G-10—stand ready to lend the IMF specific amounts of their currencies to finance IMF drawings by other G-10 members if necessary to cope with or forestall an impairment of the international monetary system.

This dual approach was ultimately adopted by the IMF membership, in decisions by the G-10 in January and the IMF's Interim Committee in February.

One feature of the modification of the GAB that has been agreed is a provision permitting establishment of lending arrangements under which other countries could lend to the IMF for the same purposes as and parallel with the GAB. The IMF is currently discussing the possibility of a parallel lending arrangement with Saudi Arabia.

We believe that the proposed increase in IMF resources represents a reasonable balance between the need to assure that the IMF has adequate funds to meet potential demands for temporary official balance of payments financing in normal circumstances and the desirability of positioning the IMF, on a standby basis, to respond to extraordinary financing problems that could arise. Given the present strains on the IMF's liquidity and the prospects that its usable resources will be drawn down to very low levels in the period immediately ahead, the proposed increase in IMF resources should be implemented by the end of 1983.

Question 3. It is the understanding of the Committee that the Administration will soon be requesting the Congress to authorize U.S. participation in a new facility to be affiliated with the Inter-American Development Bank—the Inter-American Investment Corporation (IIC)—which will focus on private sector lending to the region.

What will this new corporation do that the International Finance Corporation (IFC) (an affiliate of the World Bank) is not already doing in this area?

The United States may provide as much as 40 percent of the initial resources of the Corporation ($80 million over 4 years), and Venezuela an additional 40 percent. Why have other countries shown such seeming lack of interest in this new concept?

Wouldn't it make more sense to simply wait for the next replenishment of the IFC (likely to be in fiscal year 1985) and provide additional resources to it, rather than create an entirely new institution?

Answer. Negotiations are currently underway among interested member countries of the Inter-American Development Bank (IDB) on the establishment of an Inter-American Investment Corporation (IIC) to promote private sector development in Latin America. Upon satisfactory completion of these negotiations—involving finalization of the Corporation's articles of agreement and indications by countries of their intention to participate in and contribute to the Corporation—the Administration will propose authorizing legislation providing for U.S. participation in the Corporation.

The proposed Corporation would have a different focus than the IFC. As an affiliate of the IDB, the IIC would give priority to investments, through loans or equity, in small and medium scale private enterprises in Latin America. Thus, the IIC would generally tend to concentrate on smaller scale enterprises than the IFC; while the IFC finances both private and "mixed" enterprises, only private or "mixed" enterprises controlled by the private sector would be eligible for IIC financing; the IIC would have a truly regional focus as opposed to the global orientation of the IFC. Finally, the IIC should be viewed in the context of an overall transformation of the IDB's institutional character. With the eventual phase out of the concessional FSO window and the creation of a private sector-oriented affiliate, the IDB will evolve to respond more effectively to the development needs of the more economically advanced Latin American region and assist members to move from reliance on official financing to full participation in the international financial and trading system.

There have been three meetings of interested IDB member countries to consider the establishment of the IIC. All have been well attended and a number of countries have participated actively in the discussions. Now that the Sixth IDB Replenishment has been finalized, negotiations on the IIC should proceed more rapidly and we expect an even greater interest will be shown in the Corporation. We believe that most IDB members will eventually participate in the IIC. It is unclear at this point how many countries will be "founding" members and what the size of the initial capitalization will be. We anticipate at least $200 million, and to the extent that the capitalization is larger than $200 million, the United States and Venezuelan shares each will fall from a maximum of 40 percent.

The Corporation would not be an "entirely new institution" but as an affiliate of the IDB, it would share IDB headquarters and rely on the IDB administrative and personnel support infrastructure. Though the effective operation of the IIC would require hiring a small cadre of experts versed in venture capital investment, IDB economists would provide analytical and country-specific support. Furthermore, the Corporation with its special expertise and private sector orientation would bring a new dimension and perspective to IDB operations and programs. With regard to the IFC capital increase, which could be as early as fiscal year 1985, the rationale, activities, and funding amounts involved are all matters for future discussion among IFC member governments but would reflect a global perspective independent from (and certainly not duplicating) the activities of the IIC.

Question 4. The current recession in the industrial countries has put tremendous pressure on the international monetary system, particularly in the form of excessive borrowing by developing countries from the commercial banking system in an attempt to counter the impact of the recession on their economics. This excessive borrowing now threatens the stability of the entire system.

Do you think that the IMF should play a larger role in the future in monitoring such borrowing?

Will the United States take a leadership role at the Fund in developing the necessary guidelines within the Fund for carrying out this function?

What kind of reception to such an initiative can we expect from other member countries?

Answer. The IMF's guidelines for implementing the surveillance responsibilities established by the Articles of Agreement provide for consideration of the size and character of external borrowing arrangements in assessing countries' economic policies and performance, and we have been urging the Fund to give increased attention to the nature and sustainability of external borrowing arrangements in its discussions with borrowing countries. The IMF also periodically prepares comprehensive reports on capital market developments for review and discussion by the Executive Board.

We intend to emphasize these aspects of the IMF's work and to urge that the Fund's efforts in the area of collection and publication of data on external debt be strengthened. We believe that the IMF membership in general is aware of the importance of the debt question and will be receptive to a strengthening of IMF efforts in this area.

Question 5. One of the major foreign policy initiatives of the Reagan Administration during the last Congress was its Caribbean Basin Initiative—a major part of which was to provide $350 million of highly concessional funds to the region. Yet, the proposed replenishment of the FSO, the concessional loan window of the IDB which assists many of the same countries, is only $750 million, down in size by $1 billion from the last replenishment. As you know, I amended the CBI aid legislation to express the sense of Congress that the IDB lending ability through this replenishment to Caribbean Basin countries should be increased by at least 15 percent per year through 1987. What is the logic behind asking the Congress to believe that these countries are in dire straits, while the Administration refuses to work for additional funds being made available at the multilateral level?

Answer. The resources provided to the Caribbean Basin Initiative (CBI) and to the replenishment of the Fund for Special Operation (FSO) should be viewed as complementary and equally necessary. The CBI and FSO are both designed to support economic growth and stability in Latin America. They do so, however, in totally different ways. The financial assistance component of the CBI is designed to provide immediate, quick-disbursing, balance of payments assistance. Projects funded through the FSO are designed to strengthen the economics of borrowing members by increasing their productive capacity over time. Because the FSO only funds projects, its disbursements are expected to be slower than funds provided through the CBI. The average disbursement period for an IDB project is 5 to 8 years.

In addition, to target resources to the specific Caribbean Basin countries of interest to the United States, it is more efficient to provide funds on a bilateral basis than through the FSO. Almost half of the Inter-American Development Bank's (IDB) FSO eligible countries are outside the Caribbean Basin. Moreover, the distribution of FSO resources within the Caribbean would be subject to internal IDB programming considerations which might or might not result in the distribution designed by the United States.

Overall IDB lending under the recently concluded IDB Sixth Replenishment is expected to increase by approximately 14 percent per year. Because the poorer countries will be receiving the bulk of new replenishment resources it is possible, if their absorptive capacities permit, that their annual rate of growth could reach 18 percent.

The Administration has negotiated replenishments in the MDBs that will permit significant growth in MDB lending to the world's developing countries. In addition, in fiscal year 1983, we have met all of our existing financial obligations to the MDBs with the exception of IDA, which Congress continues to view critically.

Many of the developing countries are in dire straits. The United States is trying to address this situation by seeking an increase in IMF resources and in the amounts available under the General Arrangement to Borrow.

Question 6. Many critics believe that austerity measures imposed by the IMF are too stringent and unnecessarily retard economic growth. IMF conditions typically require reduced imports, increased exports, lower domestic budget deficits and increased taxes. In the recent past the United States has criticized the IMF for being too lenient. Has this viewpoint changed?

Answer. The primary objective of IMF financial operations is to foster adjustment policies aimed at achieving sustainable balance of payments positions conducive to economic growth and stable prices. This Administration has been working actively within the IMF to strengthen the Fund's ability to promote this objective:

We have sought to limit the use of IMF resources in cases where member countries could obtain other sources of finance, hopefully in conjunction with policy adjustments recommended by the IMF during its regular consultations process.

We have attempted to ensure that IMF supported programs aim toward sustainable current account positions and provide a framework for the pursuit of stable real growth.

We have also sought to strengthen the linkage between the provision of IMF financing and the actual implementation of needed policy measures.

The IMF has, in our view, been responsive to the need to help promote short to medium-term balance of payments adjustment and should be well prepared after the proposed increase in its resources, to play a central role in the resolution of current international financial strains.

The IMF does not support austerity as an economic goal or as "punishment" for policy mismanagement. By making financial resources available, the IMF in fact provides countries additional time and scope to make economic policy adjustments at higher levels of imports and economic growth than would otherwise be possible. In its response to individual countries in balance of payments difficulties, the IMF does not have one adjustment prescription or one set of performance criteria for every financial arrangement. Rather, the IMF seeks to analyze the balance of payments problems facing a country and to help devise solutions appropriate to those problems. These solutions frequently involve policies aimed at increasing production, investment, savings, imports and exports. The IMF's Extended Fund Facility was specifically established to provide medium-term support for countries trying to overcome structural maladjustments that are reflected in slow growth and weak external positions. The IMF frequently supports changes in exchange rates, interest rates, producer prices, and tax systems directed specifically to stimulate the supply of domestic goods and services as well as increase reliance on market forces.

As crucial as such policies are for sustained growth, their beneficial results may take some time to come through, and an economy facing an immediate balance of payments crisis caused by excess demand and an array of inappropriate policies may have to go through a difficult period. This is unfortunately the case in several large developing countries, including Mexico, where aggregate demand reached a level which could not be sustained by domestic production and foreign capital inflows. The problems in several of these cases were aggravated when lenders became concerned about the ability of the countries to service their external debts, and lending to these countries slowed dramatically. In the absence of needed policy adjustments, foreign reserves were soon depleted, and normal international financial transactions of the country were disrupted. Under severe financing constraints, imports and growth rates declined sharply, further reducing the confidence necessary for investment and capital inflows. In short, some countries were facing extreme problems which, if not addressed, would have had severe consequences for domestic economic activity and social stability, as well as for international trade and finance.

In light of such financing constraints, adjustment is inevitable, with or without the IMF. The key question is not whether economic conditions are less than ideal during the period of IMF supported adjustment, but what adjustment would have been without IMF financing and policy advice. It is important to remember that the IMF does not cause payments problems, and it cannot eliminate the need for policy measures to solve those problems. The IMF does, however, through its temporary financing and policy advice, provide for more orderly adjustment while minimizing the social and economic costs. IMF support buys time for countries to make the required policy adjustments without resorting to more draconian or more restrictive measures which can be economically and politically disruptive at home and harmful to international trade and prosperity.

Question 7. The World Bank has announced plans to speed up lending to the developing countries in order to help relieve current economic pressures including the burden of international debt.

Does the Administration support this lending acceleration? Are credit standards being reduced?

How much help will this be in relieving the debt burden pressures?

A number of experts have described the current situation as a liquidity crisis in part related to too much debt financed short term. Since the World Bank is better structured to lend long term than private commercial banks would it make sense to expand the rule of the World Bank in supplying credit to the middle and upper income developing countries?

Answer. On February 22 the IBRD Executive Directors approved a Special Action Program proposed by Management to help borrowers undertaking appropriate adjustment measures to sustain development programs. The Program—which will not reduce for appropriate macro-economic or sectoral policies or standards of project analysis—consists of temporary changes in lending procedures which will result in an additional $2 billion in IBRD disbursements over a 24-month period. However, no additional loan commitments were authorized. No increase in the 10 percent limit of total lending for structural adjustment and program lending was approved.

The United States supported the proposal in light of the current international financial situation and our desire to avoid a contraction of international money and credit. We view it as a limited, temporary set of lending policy shifts available only to those countries that are pursuing appropriate adjustment and development policies.

The Special Action Program is not intended as a response to debt burden pressures, although to the extent that it enhances development efforts it will also contribute positively to the overall economic environment.

The United States considers the World Bank an important institution for furthering long-term development and will continue to work with other Bank members to improve the overall effectiveness of the Bank's lending operations. We believe, however, that middle and upper income countries will have to rely primarily on private capital markets for external financing. We have encouraged and are supporting the Bank's efforts to enhance its catalytic role, including efforts at increased co-financing with private lenders.

Question 8. It has been reported that the rescue package for Brazil has hit some snags because smaller regional banks have pulled back on inter-bank credits.

How serious is this situation? Is it likely to cause the rescue package to fail? What would happen if Brazil simply froze payments on its loans? Are the banks reducing inter-bank credit U.S. banks or are some foreign banks also reducing credit? Is the

U.S. Government encouraging these banks not to reduce credit? Should the government take a position?

Answer. Reports that a pullout by regional banks was threatening the overall financial package for Brazil have proved to be exaggerated. In fact, agreement has now been reached on a financial package which includes: medium-term loans amounting to $4.4 billion from commercial banks; a rollover of $4.7 billion in medium- and long-term loans maturing this year; confirmation of $9.2 billion in trade credit lines; and approval by the IMF Executive Board of Brazil's request for a $5.5 billion Extended Fund Facility and CFF drawing.

Discussions are continuing on a restoration of inter-bank deposits with Brazilian agency banks to their mid 1982 level and sufficient progress has been made to insure that the overall financing package can proceed.

From the outset, the Brazilian authorities, private creditors, foreign governments and the IMF have recognized that a suspension of payments on Brazil's external obligations would have been highly disruptive for both the Brazilian and world economy and the international financial system. Consequently, all parties have sought to find a solution to the current financial situation that would enable Brazil to obtain sufficient financing to undertake in an orderly manner the domestic economic adjustments that are required. The United States has strongly supported and encouraged this effort, including by providing a number of short-term loans to help Brazil maintain a liquid foreign exchange position. We have not, however, told banks what their lending decisions should be in the belief that such decisions are and should remain the sole responsibility of the individual banks.

Question 9. The financial press continues to report that a sharp drop in oil prices spells trouble for the international banks.

How valid is this assessment? In your opinion, what impact would a drop in oil prices to say—$20 a barrel have on the health of the banking system?

Answer. There is no generalized answer to the question. Some individual lenders heavily engaged in lending in the energy sector and to oil exporters face difficulties, but this does not mean that the health of the world or U.S. banking systems would be at risk because of the decline in oil prices. To the extent that oil prices fall and the import costs of non-oil exporting less developed countries are reduced, the balance of payments positions of these countries will improve. They will find it easier to repay their loans, and lenders' portfolios will strengthen accordingly.

To the extent that oil exporting developing nations (such as Mexico and Venezuela) lose oil income, the contrary is also true. Their balance of payments positions will weaken. But there is an offsetting element that would be a positive factor for all concerned: to the extent that the fall in oil prices leads to a reduction in inflation and interest rates, the debt burden of borrowing countries would be reduced and their debt servicing capacity would improve. The position of individual banks would differ, depending on their loan exposure to individual projects and to individual countries.

Question 10. During my recent trip to Latin America I discussed economic matters at length with government officials. Universally the leaders in these countries plan to improve their balance of payments problems by reducing imports and increasing exports. These plans are consistant with IMF assistance conditions.

Obviously, the LDCs want the developed nations to purchase more of their exports while the LDCs will follow policies to restrict imports. Isn't this a self defeating cycle? Can the developed nations afford to accommodate such trade policies? In the short term? Long term? Will the developed countries cooperate? Can the United States run a consistant trade deficit and still have an economic recovery?

Answer. Events over the past 6–9 months have demonstrated forcefully that some developing countries have undertaken inadequate economic adjustment measures and excessive borrowing. These countries will have to implement corrective economic policies to restore their external positions to a sustainable basis. In some cases, this may require short run reductions in domestic economic growth, increased emphasis on exports and lower imports. In other cases—for example, Mexico—the required economic adjustments can be achieved with higher levels of growth and imports. However, it is likely that the adoption of an IMF supported program will involve higher levels of growth and imports than would have been possible in the absence of the program because of the increased external financing that would be available with the program.

The restoration of economic and financial stability in the developing countries is essential in order to permit them to attract the investment and loans needed to finance the trade deficits which will provide the net transfer of resources from industrial countries necessary for their longer term development. Moreover, the establishment of credible economic growth and the maintenance of open markets in developed countries will also be important in enabling the developing countries to earn the revenue needed to service debt and pay for imports. In this context, the basis for solid observable growth in the United States and abroad is being established. However, governments must avoid pressures for excessive monetary and fiscal stimulus which could result in renewed inflation and higher interest rates. In addition, the industrial countries must resist protectionist actions which would cut off a major channel of balance of payments adjustments by developing countries. As the world's largest economy, the United States has a major responsibility to resist protectionist pressures. The concern expressed in some quarters that such measures are needed because the U.S. trade deficit acts as a drag on economic recovery is unwarranted. The trade deficit in part reflects the fact that the United States is growing faster than its major trading partners—and this is likely to be the case during much of 1983. The deficit on merchandise trade is to a large extent offset by a surplus on services trade, and the overall deficit would be reduced by any significant drop in oil prices. A deficit can be sustained as long as we continue to pursue economic policies which make the United States a good place to invest and enable us to attract the capital flows to finance the deficit.

Question 11. Economic growth for the developed countries has been projected at 1.8 percent for the developed countries in 1983.

Is this rate of growth sufficient to end the worldwide recession and improve the creditworthiness of the LDCs?

Several experts have expressed the view that this economic growth rate will top 1.8 percent. What is your view?

What effect will substantially lower oil prices have on world economic Growth? How low do you think oil prices will go?

Answer. A number of forecasts made around the turn of the year projected economic recovery in the developed countries on the order of 1½–2 percent. These forecasts assumed that oil prices during 1983 would remain at the $34 level. In light of oil market developments since the turn of the year, these forecasts would need to be revised upward. A substantial decline in oil prices could provide an important boost to economic growth rates. Rules of thumb suggest that a 10 percent decline in prices will add up to one-half percent to real growth rates over the course of 1–2 years.

Even without revising the growth upward, most analysts foresee a strengthening recovery over the course of 1983. Our own view is that real growth in the industrial countries will be on the order of 3½ percent (4thQ to 4thQ) over the course of 1983. After 3 years of virtually no growth, this would clearly represent recovery of real growth.

A strengthened growth environment such as we now expect will benefit the export potential for LDCs. World trade declined in real terms in 1981 and 1982, depressing LDC export earnings. A real growth recovery will in turn lead to world trade growth of 4 percent or so during 1983. These higher export earnings in turn will improve LDC creditworthiness.

Predicting oil price levels is very difficult. Last December oil prices averaged about $34 a barrel. Today, the average price is about $30. A reasonable range for 1983 is somewhere between $25 and $29.

Question 12. Yesterday's Wall Street Journal (WSJ) reported the possibility that the International Bank for Reconstruction and Development (World Bank) plans to substantially increase its annual contribution to its soft loan affiliate, the International Development Association. The WSJ further reported that the World Bank is flush with funds because fewer poorer countries are seeking loans.

Do you approve of the World Bank using its resources to increase concessionary lending? Will this development have any effect on Administration proposals to fund other development banks?

Answer. IBRD fiscal year 1983 income is now expected to be significantly greater than initially projected, largely due to capital gains on the Bank's liquidity portfolio. If income develops as currently forecast, Management intends to recommend a larger than normal (e.g., $200–$250 million) transfer to IDA out of fiscal year 1983 net income. This issue is not expected to come before the Board until after the end of the fiscal year on June 30, 1983.

We believe that market uncertainties make it too early to accurately guage fiscal year 1983 net income prospects, and that it is thus too early to discuss any specific number or possible range for a fiscal year 1983 net income transfer to IDA. We also believe that when the Board addresses the issue in July, very careful attention must be accorded to the impact of any transfer on the Bank's overall financial situation in the current economic environment.

The "IDA transfer" issue will not have any impact on the Administration's proposals to fund other development banks.

Question 13. Do you recommend structural or regulatory changes to limit private commercial bank exposure in LDC lending? How can we prevent a recurrence of the present situation where so many of the international banks have an imprudent level of exposure in LDC credits?

Answer. Several possible changes in the regulatory environment are being actively considered by the supervisory and regulatory authorities. My prepared statement before the Committee described some of the questions being considered, and Messrs. Volcker, Conover and Isaac have testified on these issues at greater length. The relevant agencies are reviewing these issues intensively, and I would prefer to respond in greater detail after hearing their views.

[Whereupon, at 11:55 a.m., the committee adjourned, subject to call of the Chair.]

GLOBAL ECONOMIC OUTLOOK

WEDNESDAY, APRIL 13, 1983

UNITED STATES SENATE,
SUBCOMMITTEE ON INTERNATIONAL ECONOMIC POLICY
OF THE COMMITTEE ON FOREIGN RELATIONS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 11 a.m., in room SD-419, Dirksen Senate Office Building, Hon. Charles McC. Mathias, Jr. (chairman of the subcommittee) presiding.

Present: Senator Mathias.

Senator **MATHIAS**. The subcommittee will come to order.

Gentlemen, I apologize for holding you up this morning. I seem to have run into every piece of road construction that is underway. I suppose it is good news and bad news. It is good news that I am here. It is bad news that I am late. It is good news that people are out working.

We are here for the seventh Foreign Relations Committee meeting that has been held this year on stresses and strains in the international financial system. To date, we have heard from three former Secretaries of the Treasury, as well as the current Secretary. We have heard as well from the Secretary of State, from bankers, economists, academicians, and I think it is fair to say that none of the witnesses have been particularly optimistic.

All of them have emphasized that the global economy is experiencing severe strains which, if not managed, will get considerably worse. A number of the witnesses have emphasized the absolute necessity for restoration of global economic growth if the problems of debt, stagnant world trade, low commodity prices, rising unemployment, and underutilized industrial capacity are to be resolved.

It is within this context that we are pleased to have appearing before us today two witnesses who will provide us with their assessment of the impact of global economic conditions on labor and industry in the United States and with their recommendations for the measures necessary to restore economic growth in the country and around the world.

Our two witnesses are Mr. Henry Schechter, director, Office of Housing and Monetary Policy, AFL-CIO, and Mr. William L. Hoppe, manager of economic studies for Bethlehem Steel, speaking on behalf of the Iron & Steel Institute.

Gentlemen, do you have a preference as to who goes first? Mr. Schechter, you are in the middle. We will start with you.

STATEMENT OF HENRY B. SCHECHTER, DIRECTOR, OFFICE OF HOUSING AND MONETARY POLICY, AFL-CIO, WASHINGTON, D.C.

Mr. SCHECHTER. Mr. Chairman, I appreciate the opportunity to present to you the views of the AFL-CIO on the international financial system.

American participation in the international financing system has reflected primarily the viewpoint of the leaders and the central bank. Large amounts of financial capital from OPEC countries, along with U.S.-generated capital, were placed in foreign loans that represented high risks, decreasing the supply and raising the cost of capital for domestic investment.

Pursuit of a tight money policy for an extended period by the Federal Reserve caused a significant rise in the value of the dollar over other currencies, as there was inadequate international coordination to counteract large trade destabilizing changes in currency values. The consequent adverse effect upon U.S. merchandise trade balances caused increasingly great losses of employment for U.S. workers.

International financial and economic relationships are inextricably a product, in large part, of the monetary policies pursued by the individual countries engaged in international trade. The most auspicious, significant example is that of the monetary policies pursued by the United States and Japan over the past 3 years. The difference in monetary policies and interest rates led to a significant change in relative values of the two countries' currencies in international exchange.

Because of the high U.S. interest rates, the dollar gained in value relative to that of foreign currencies, particularly the Japanese yen and the German mark between 1980-82. As the yen fell in value relative to the value of the dollar, the price of Japanese-produced goods declined relative to that of U.S.-produced goods.

During the seventies, the American share of the world market for manufactured goods declined 23 percent, and our share of our domestic market also declined.

The U.S. merchandise trade balance suffered a record $48 billion deficit in 1982—that is including the cost of insurance and freight as well as the cost of the merchandise—and the deficit is expected to be greater in 1983, as we continue to import more than we expected.

A large part of the drop in exports, and thus in U.S. employment, is due to the financial crisis currently facing less developed countries. In 1982, for example, non-Communist, less developed countries purchased 40 percent of our exports. Similarly, exports to non-OPEC, less developed countries made up to 29 percent of U.S. exports in 1981. But exports to these nations decreased almost 10 percent in 1982. Last year, for example, Mexico reduced its imports of U.S. goods by 60 percent and Argentina by 40 percent.

OPEC had pushed up oil prices in a second round of major price increases during 1979-80. Unlike earlier similar experience, this round led to financial distress because the less developed countries had raised their debt service levels because of earlier OPEC increases. In addition, the developed nations have engaged in long-term contractionary policies, which pushed the world into a deep and prolonged recession.

Commodity prices, which less developed countries heavily depend upon for export earnings, dropped sharply. Their export earnings dropped, leading to increased foreign currency borrowing needs to finance imports. Mexico and other large debtor countries are now slashing their imports, with encouragement from IMF. That will mean a reduced market for U.S. goods.

Some information regarding the fees and surcharges on money extended to borrowers in financially distressed less developed countries has recently been revealed. From these special fees and interest rate premiums, banks have extracted an additional $800 million from Mexico, which they consider their price for continuing to do business with that near-bankrupt nation.

In the end, the additional weight of these fees and interest premiums may cause another financial crisis. To prevent banks from profiteering at the expense of the developing countries, and misusing IMF resources which are ultimately provided by taxpayers in donor nations, these excess fees and premiums must be prevented.

The International Monetary Fund is supported by quota subscriptions of its member countries. The United States has the largest quota subscription.

Under recent agreements among members of the IMF calling for increases in the national quota and in the General Agreements to Borrow Fund, the United States will have to agree to obligations for another $8.5 billion. That would bring the total U.S. Treasury cumulative debt increase related to IMF operations to about $15 billion.

Private banks in the United States as well as in other countries that engage in international lending are the beneficiaries of the IMF expanding operation funded through a significant degree with U.S. Treasury money. Since the Congress approves large contributions to the IMF, which then are used to help rescue the international loans which the private banks have made, the Congress has a responsibility to examine more closely the type of lending that goes on and leads to the crises which require more and more IMF operations.

There should be procedures adopted to assure that the banks that have made loans to countries which then become financially troubled and cannot repay as scheduled, will absorb part of any losses. Furthermore, the banks should not be permitted to profit by charging high fees for the refinancing of the loans when they are rescheduled under IMF intervention.

The AFL-CIO Executive Council at its meeting this last February adopted a policy statement on the International Monetary Fund, reading:

> The AFL-CIO recognizes the serious consequences of potential large debtor nation defaults to the world economy and the need for IMF action to help debtor nations out of their precarious positions. It also recognizes, however, the cost in dollars to U.S. taxpayers and in jobs to U.S. workers.
>
> AFL-CIO supports U.S. participation in an expansion of U.S. capital funds, provided that legislation is enacted to accomplish the following.

And the statement went on to state a number of legislative and U.S. policy changes that the AFL-CIO believes must be part of the legislative package.

Several of the legislative actions call for an expanded monitoring function by the Federal Reserve Board to increase its surveillance of U.S. bank foreign lending, and to restrict such lending, with due consideration of the impact of credit availability and cost in the U.S. economy, as well as the capability of repayment.

It would also be authorized and directed to require special bank reserves, that would be available to provide a part of future U.S. contributions to IMF fund expansion.

Finally, the Federal Reserve Board should be required to report regularly to the Congress on the volume, terms, and quality of foreign credit extension by U.S. banks and its effect upon the U.S. economy with respect to international trade positions and the availability and cost of credit in the domestic economy.

The AFL-CIO Executive Council also recommended that private banks that have extended loans to foreign borrowers should share in the burden of any rescue efforts. In that connection, for the current and future efforts, I would urge the Congress to consider a proposal by a senior management officer of Barclay's Bank International, which has been summarized as follows:

> Barclay's plan would allow banks to sell troublesome country loans to their central banks at a discount from face value on the condition that the money be used in new lending to support domestic—not foreign—economic recovery, such as the financing of exports. The central banks would collect on the loans, as they mature, but if the debtor countries were unable to pay the loans off, the bad loans would revert to the lending bank's account, where they would ultimately be declared a loss.

Another AFL-CIO recommendation is for the Secretary of the Treasury to seek a change in IMF policies to reduce emphasis upon having aided countries, reduce imports and increase exports, and to place more emphasis upon developing their own domestic markets. This would benefit workers in the aided countries and in the United States.

I would just take a minute on the last point. As a matter of conditionality for its program of aid, the IMF generally requires an aided country to reduce imports and increase exports. It also very frequently requires budgetary policies of the aided country which require a decrease and cutback in social programs.

In the course of doing both of those, and having both of those policies followed, of course, the domestic market of the aided country is being contracted. At the same time, to the extent that the countries, under the encouragement of IMF, succeed in increasing their exports to the United States, and increasing our negative balance of trade, it means greater unemployment in the U.S. economy, and when the U.S. economy is reduced to a much lower level, the developing countries of the world and even the developed countries will also suffer, because we are the largest market in the world.

So, we are for, if not a complete reversal, at least a great modification of that IMF policy.

Thank you.

Senator MATHIAS. Thank you very much, Mr. Schechter. We will reserve questions until both of you have spoken.

I might say, Mr. Schechter, you summarized very skillfully your statement, but the full statement will appear in the record.

Mr. SCHECHTER. Thank you.

[Mr. Schechter's prepared statement follows:]

PREPARED STATEMENT OF HENRY B. SCHECHTER

I appreciate the opportunity to present to you the views of the AFL-CIO on the International Financial System.

American participation in the international financing system has reflected primarily the viewpoint of the lenders and the central bank. Large amounts of financial capital from OPEC countries, along with U.S.-generated capital, was placed in foreign loans that represented high risks, decreasing the supply and raising the cost of capital for domestic investment. Pursuit of a tight-money policy for an extended period by the Federal Reserve caused a significant rise in the value of the dollar over other currencies, as there was inadequate international coordination to counteract large trade destabilizing changes in currency values from developing. The consequent adverse affect upon U.S. merchandise trade balances caused increasingly great losses of employment for U.S. workers.

That trend will tend to continue under conditions prescribed by the International Monetary Fund for countries being assisted; namely, that they export more and import less. The international financing policies, thus, seem to be little concerned about acheivement of balanced growth of the various domestic economies.

Since 1980, the dollar has appreciated more than 20 percent. While the dollar has depreciated somewhat in the last few months, particularly against the currencies of other industrialized countries, it has retained its value against the overall basket of currencies of our trading partners. For example, in February 1983, the index of weighted average exchange rates of the U.S. dollar was 40 percent higher than it was during January of 1980.

International financial and economic relationships are inextricably a product, in large part, of the monetary policies pursued by the individual countries engaged in international trade. The most auspicious, significant example is that of the monetary policies pursued by the United States and Japan over the past 3 years.

As a supplement to the traditional tools of monetary policy that are employed by the Federal Reserve Board in the United States, the Bank of Japan employs, from time to time, a supplementary tool which is dubbed "window guidance," (to the commercial banks of Japan). "Window guidance" is a form of credit restriction, generally a percentage restriction on the annual increase in credit extension. It is similar to a part of the credit controls employed in the United States for about 3 months in 1980, which brought about a quick reduction in U.S. interest rates for about half a year. Japan, which employed its credit controls more often, as needed, managed to maintain a relatively low level of interest rates during the 3 years 1980–82.

On the other hand, during all but a few months of those 3 years, the U.S. monetary policy was to restrict the growth of the money supply and depend upon the resultant high interest rates to reduce aggregate economic demand to fight inflation. The record is painfully clear. Given the levels and the distribution of U.S. household income, it required a long period of high interest rates before inflation could be brought down. In the process, the interest-sensitive industry sectors (housing and autos) had their activities greatly reduced, and small business and farming suffered from high debt service burdens. This all led the U.S. economy into its worst post-World War II recession.

Incidentally, the direct restriction of credit extension used in Japan, as and when needed, was much more effective in combatting inflation than the U.S. high interest rate policy which, at first, adds to inflation.

The comparative levels of interest rates in the United States and Japan during the 3 years are illustrated by Table I showing the prime business loan rates in each country. The difference in monetary policies and interest rates led to a significant change in relative values of the two countries currencies in international exchange. Because of the high U.S. interest rates, many foreigners wanted to exchange their currency for dollars to buy U.S. securities. The dollar gained in value relative to the value of foreign currencies, particularly the Japanese yen and the German mark between 1980 and 1982. For example, as shown on Table II, whereas it used to be possible to get only about 200 Japanese yen for one U.S. dollar, it became possible in

1982 to get 270 yen for $1. (It is now back to about 230 to 1.) As the yen fell in value relative to the value of the dollar, the price of Japanese produced goods declined relative to that of U.S. produced goods. That was one of the main reasons that Japanese machine tool producers are now selling about half of the machine tools being bought in the United States, and exports of U.S. machine tools are way down. Many other U.S. products were similarly affected.

TABLE I.—COMMERCIAL BANK LENDING RATES TO PRIME BORROWERS UNITED STATES AND JAPAN: 1980–82

	United States	Japan
1980:		
January	15.25	6.71
February	16.75	6.95
March	19.50	7.70
April	18.50	8.60
May	14.00	9.40
June	11.50	9.27
July	11.00	9.34
August	11.50	9.27
September	13.00	8.99
October	14.50	8.82
November	17.75	8.58
December	21.50	8.30
1981:		
January	20.00	8.00
February	19.00	7.86
March	17.00	7.74
April	18.00	7.52
May	20.50	7.33
June	20.00	7.18
July	20.50	7.14
August	20.50	7.20
September	19.50	7.20
October	18.00	7.09
November	16.00	7.08
December	15.75	6.95
1982:		
January	15.75	6.77
February	16.50	6.70
March	16.50	6.65
April	16.50	6.38
May	16.50	6.36
June	16.50	6.34
July	15.50	6.33
August	13.50	6.32
September	13.00	6.35
October	12.00	6.35
November	11.50	6.35
December	11.50	6.35

Source: "World Financial Markets." Morgan Guaranty Trust Co.

TABLE II.—*Yen/dollar exchange rates 1980–83*

1980:	
January	237
February	244
March	248
April	250
May	228
June	217
July	221
August	223
September	214

October	209
November	213
December	209
1981:	
January	202
February	219
March	208
April	214
May	220
June	224
July	232
August	233
September	229
October	231
November	223
December	218
1982:	
January	224
February	235
March	241
April	244
May	239
June	251
July	255
August	259
September	263
October	271
November	264
December	241
1983:	
January	232

Source: Calculated from Federal Reserve Bulletin data.

During the seventies, the American share of the world market for manufactured goods declined 23 percent, and our share of our domestic market also declined. This deindustrialization resulted in the loss of at least 2 million jobs.

The U.S. merchandise trade balance suffered a record $48 billion deficit in 1982, and the deficit is expected to be greater in 1983, as we continue to import more than we expected.

The result of the dollars appreciation has been a sharp drop in our net exports. The drop in real net exports, measured in 1972 dollars, from the first quarter of 1981 to the fourth quarter of 1982 was $21 billion. This directly explains 69 percent of the decline in real GNP durng this period. According to Data Resources, Inc., net export earnings generate additional domestic spending with a multiplier of two. Thus, they conclude that the drop in net exports is the principal source of our economic problems.

The effect on workers in the United States has been devastating. In March of this year, unemployment remained at destructive levels. A total of 11.4 million persons were unemployed, and the unemployment rate (including military personnel in the employment total) was 10.1 percent.

A large part of the drop in exports, and thus in U.S. employment, is due to the financial crisis currently facing less developed countries. In 1982, for example, non-Communist, less developed countries purchased 40 percent of our exports. Similarly, exports to non-OPEC, less developed countries made up 29 percent of U.S. exports in 1981. But exports to these nations decreased by 9.8 percent in 1982. Last year, for example, Mexico reduced its imports of U.S. goods by 60 percent and Argentina by 40 percent.

This downturn resulted from the financial crisis now affecting the developing countries. U.S. banks, following herd instincts, built up their loans to less developed countries at unprecedented rates, while domestic markets were starved for capital. This loan growth began in the early 1970's as a result of the first round of OPEC oil price increases. The OPEC countries built up huge deposits in United States and other Western banks. The banks, in turn, financed the foreign exchange needs of less developed countries which resulted from their import needs, particularly of oil. This earlier "recycling" phase didn't cause a financial crisis such as faces the world today.

OPEC pushed up oil prices in a second round of major price increases during 1979–80. Unlike the earlier experience, this round did lead to financial distress in the developing world. This is because the less developed countries had already pushed up their debt service levels because of earlier OPEC increases. In addition, the developed nations have engaged in long-term contractionary policies, which pushed the world into a deep and prolonged recession. As a result, commodity prices, which less developed countries heavily depend upon for export earnings, dropped by unprecedented amounts for the post-war period. Their export earnings dropped, leading to increased foreign currency borrowing needs to finance imports. This pushed debt service to unsafe levels, particularly when gauged against their exports. In addition, their debt service ratios were worsened by high interest rates—since most loans are now geared to the London Interbank Offer Rate (LIBOR) on a floating basis.

For a while, U.S. banks lent more, but they increased rates, and fees, while shortening maturities. When Mexico ran out of money last year, the whole huge debt pyramid was in danger of crumbling. Mexico and other large debtor countries are now slashing their imports, with "encouragement" from the IMF, so that they can meet enlarged debt service payments required under the IMF rescheduled debt payment program. That will mean a reduced market for U.S. goods, but as inventory building gets under way, there probably will be more U.S. imports of foreign goods. The net effect of the changing import-export balance on American jobs in 1983 is likely to be negative.

Commercial banks generally attempt to keep the terms of their loan agreements private. But some information regarding the fees and surcharges on money extended to financially distressed less developed countries borrowers has recently been revealed. The most remarkable example of bankers' self-interest that has been made public are the fees and interest surcharges added on to the rescheduled and new loans made to Mexico.

From these special fees and interest rate premiums, banks have extracted an additional $800 million from Mexico, which they consider their price for continuing to do business with that near-bankrupt nation. Without the IMF's infusion of cash, however, the possibility exists that Mexico would default on the loans, and the banks would have had to write them off totally. Accordingly, the IMF should prevent commercial banks from misusing IMF resources to make excessive profits on shaky loans which the banks were initially frantic to extend but on which they would have had to absorb losses if the IMF hadn't stepped in.

Moreover, by adding these extra kickers, banks may once again be acting in a short-sighted way. While the banks may reap a near term bonanza, their actions add to the already dangerously high debt service burdens of the financially unstable borrowing nations. In the end, the additional weight of these fees and interest premiums may cause another financial crisis.

As Martin Feldstein, Chairman of the President's Council of Economic Advisors, stated in a speech made on March 7: "By increasing the total interest bill of the borrowing nations, a higher risk premium increases the risk of nonrepayment."

In the case of Mexico, the banks levied a rescheduling fee on 1 percent, plus an interest rate premium between 1⅞ and 2⅜ percent above the London Interbank Offer Rate (LIBOR), as their reward for rescheduling $20 billion in short-term loans to 8-year loans. Averaging 3 plus percentage points, this adds $600 million in profits to the rescheduled loans. (Note, the 1 percent rescheduling fee would have to be amortized over the life of the loan under financial regulators' newly proposed regulations.)

Under IMF pressure, the banks were induced to lend $5 billion in new money to Mexico. For this, they are charging a fee of 1¾ points, plus a surcharge of 2¼ points over LIBOR. This extra 4 points on the $5 billion in new loans generates another $200 million in bank profits.

These fees and interest surcharges extract $800 million in additional payments from Mexico. Ironically, just a few years ago, the same banks were making loans to poor countries at less than the U.S. prime rate and only a fraction above LIBOR.

Yugoslavia is another example of banks using IMF bailouts to profiteer at the expense of a financially strapped nation. Commercial banks have put together a $4 billion loan package, consisting of $600 million in new money; rescheduling $1.4 billion in medium-term loans coming due this year; and rolling over from $1.8 to $2 billion in short-term credit. In return, Yugoslavia must pay 1⅞ over LIBOR, or 1¾ over the U.S. prime rate, for the new money and intermediate-term reschedulings. For rescheduling Yugoslavia's short-term credit, the banks have charged 1⅜ points over LIBOR, or 1¼ over the U.S. prime rate, with a fee of ¼ percent.

The irony of these extra fees is that the banks maintain they are needed to compensate them for the additional risk they must bear. But this is self-defeating. The added fees and interest premiums themselves are a major source of risk because they raise less developed countries' debt service-to-total export earnings ratios even higher. These debt service ratios are already in the danger zone. On long-term loans, the average ratio for non-oil, less developed countries rose from 18.1 percent to 22.3 percent between 1979 and 1982. For several countries, the debt service ratio is beyond a reasonable range. For example, in Mexico it is 129 percent, in Argentina 179 percent, in Ecuador 122 percent, in Brazil 122 percent, and in Chile 116 percent. To give an idea of the magnitude of the effect on less developed countries of raising interest rates, it is estimated that a 1 percent increase in the Eurodollar market adds $2 billion in debt service to non-oil developing countries, based on their current debt.

To prevent banks from profiteering at the expense of the developing countries, and misusing IMF resources which are ultimately provided by taxpayers in donor nations, these excess fees and premiums must be prevented. While banks may profit in the short run, just as they did when they followed their herd instincts in extending huge volumes of credit to developing nations, these fees and surcharges endanger the viability of the borrowing nations and the health of the international economy.

While the operations of the International Monetary Fund serve a useful purpose by helping member countries through difficult debt service problem periods, that operation also has a negative aspect. By providing loans to debtor countries so that they can reschedule their debt payments to private banks, it provides the private U.S. lenders with a shield against loss. It is axiomatic that, if debtor countries encounter repayment difficulties, the IMF will participate in and coordinate a refinancing plan, rescheduling the debt repayments and providing a cushion to permit such repayments. That expectation, as well as another axiom, that the "Fed" will never permit a larger international lender bank to become bankrupt, encourages the banks to make loans to developing and other countries, and to private enterprises in those countries, at higher risk than loans that otherwise would be made.

The International Monetary Fund is supported by quota subscriptions of its member countries. The United States has the largest quota subscription, about 21 percent. As of the end of calendar year 1982, the cumulative net addition of U.S. Treasury debt as a result of U.S. quota subscription to the IMF was $5.1 billion, plus an additional $1.2 billion resulting from U.S. loans to the General Agreements to Borrow and Supplementary Financing facility of the IMF.

Under recent agreements among members of the IMF calling for increases in the national quota and in the General Agreements to Borrow fund, the United States will have to agree to obligations for another $8.5 billion, of which 25 percent would be paid immediately and rest drawn as needed. Given recent trends of calls from the IMF and the tremendous amount of debt rescheduling being required by developing countries and some Eastern Block countries, there is good likelihood that the entire $8.5 billion would be required before long. That would bring the total United States Treasury cumulative debt increase related to IMF operations to about $15 billion.

Private banks in the United States as well as in other countries that engage in international lending are the beneficiaries of the IMF expanding operation funded through a significant degree with U.S. Treasury money. These Treasury outlays do not appear in the budget of the United States. Although the Congress must authorize and appropriate the funds, it is not counted as an expenditure and does not show up in the budget because the United States receives what are, in effect, equity shares in the IMF and drawing or borrowing rights. However, the long-term trend has been for growth in the cumulative amount of United States outlays. Since the Congress approves large contributions to the IMF, which then are used to help rescue the international loans which the private banks have made, the Congress has a responsibility to examine more closely the type of lending that goes on and leads to the crises which require more and more IMF operations.

Furthermore, there should be procedures adopted to assure that the banks that have made loans to countries which then become financially troubled and cannot pay as scheduled, will absorb part of any losses. Furthermore, the banks should not be permitted to profit from the problems which arise from the lending and require IMF intervention by charging high fees for the refinancing and higher interest rates on the loans when they are rescheduled under IMF intervention than they had originally charged, since the debtors hadn't been able to meet repayments even with the old interest rates.

The Administration and the Federal Reserve Board and other regulatory agencies have proposed the following types of reforms:

(1) Strengthening the program for bank examiners to warn bank managements when the examiners feel a bank's foreign loans are too risky.

(2) Require banks to make more frequent public reports of their overseas loans, to give depositors and investors better information about the banks in which they place their funds.

(3) Force lenders to establish special reserves against loans to sovereign countries when loans are not being repaid properly, but such reserve requirements would not apply to countries that had rescheduled their loans and were repaying per the new schedule.

(4) Make banks spread over the life of the loan the fees they are paid when a loan is made, rather than counting it all as current earnings.

(5) Increasing the coordination among bank supervisor and the IMF to reduce risky lending.

The "tightening" regulations being proposed by the Administration and the bank regulators depart very little from the notion that the international financing business carried on by American banks is a laissez-faire activity and should largely remain that way. Such a perspective overlooks several factors:

(1) The U.S. Government, with the approval of the Congress, has contributed to the safety and support of international lending via IMF to the tune of some $6.3 billion thus far, and is being asked to add another $8.5 billion in such contributions. There can be no doubt that the Congress has a direct dollar interest in the international lending operations of the banks, should be informed about such operations much more fully and frequently than heretofore, and should establish additional necessary safeguards in laws governing such operations.

(2) To the extent that available financial capital resources are loaned, often at rates above the U.S. prime rates and with profitable loan origination fees, the availability of funds for credit in the United States is reduced and interest rates are higher than they otherwise would be.

(3) There is a much broader, albeit less direct national interest that must be exercised for the safety of the U.S. banks. Practically all of the U.S. banks have federal deposit insurance, many are nationally chartered; and they are essential for the financing of commercial and other credit needs locally and nationally, as well as the safety of "other peoples' money." Collectively the banks provide the financial underpinnings of the U.S. economy. However, at the end of 1982, the nine largest U.S. banks had outstanding over $60 billion in foreign loans, equal to 222 percent of their equity capital; more than one-half of the outstanding loan amounts are in Brazil, Mexico, and Argentina. The next 15 largest banks had $19 billion of such loans outstanding, equal to 150 percent of their capital. There are hundreds of smaller banks that each have at least $10 million in foreign loans outstanding. The large and small banks could suffer a measurable dent in their capital if there were one or more defaults by large foreign country debtors.

(4) The IMF standard practice is to require a country, that is being assisted through an IMF refinancing program, to accept certain conditions that include reductions of domestic social programs, thereby reducing total domestic economic demand for total goods and services; restrictions on and reduction of imports and increases in exports. The immediate effects are likely to be (a) to reduce the volume of U.S. imports by the country being aided, and (b) to increase exports from the aided country to the United States, and to other countries where they may displace U.S. products. A longer range effect is the retardation of a domestic market in the aided country economy as social programs to aid low-income people are cut back. The immediate and long-run effects in the United States are a reduction of a foreign and domestic market demand for U.S. products and a reduction in employment which will adversely impact upon U.S. workers.

In recognition of the significant impact that international financing operations and the role of the IMF have upon the U.S. economy and workers, the AFL-CIO Executive Council at its February 1983 meeting adopted a policy statement on the International Monetary Fund. A key part of that statement reads:

"The AFL-CIO recognizes the serious consequences of potential large debtor nation defaults to the world economy and the need for IMF action to help debtor nations out of their precarious positions. It also recognizes, however, the cost in dollars to U.S. taxpayers and in jobs to U.S. workers.

"AFL-CIO supports U.S. participation in an expansion of U.S. capital funds, provided that legislation is enacted accomplish the following:" * * *

And the statement went on to state a number of legislative and U.S. policy changes that the AFL-CIO believes must be part of the legislative package authorizing an additional $8.5 billion dollar U.S. participation in the IMF, if international financing by U.S. banks and IMF operations are to be conducted with greater responsibility and greater consideration for the effects upon the total U.S. economy and employment in the future than in the past.

Several of the legislative actions called for in the AFL-CIO statement would call for an expanded monitoring function by the Federal Reserve Board. It would be required to increase its surveillance of U.S. bank foreign lending, and to restrict such lending, with due consideration of the impact of credit availability and cost in the U.S. economy, as well as the capability of repayment. It would also be authorized and directed to require special bank reserves, that would be available to provide a part of future U.S. contributions to IMF fund expansion. Finally, the Federal Reserve Board should be required to report regularly to the Congress on the volume, terms, and quality of foreign credit extension by U.S. banks and its effect upon the U.S. economy with respect to international trade positions and the availability and cost of credit in the domestic economy.

According to an Associated Press report, a study recently published by the IMF concludes that a large obstacle to sound international banking is the difficulty that bank supervisors in a major country, such as the United States, have in getting information from bank branches set up in countries with stringent secrecy laws, which forbid the branches from giving out full information. This facilitates international financing which may be of a high-risk character but cannot be detected by the bank regulators. Such financing, whose terms can be kept secret from examiners of the bank regulatory agencies, should be prohibited by a law for branches of U.S. banks.

The AFL-CIO recommendations are made in the context of a recognition of the U.S. national financial and economic stakes involved and the need for a continuing exercise of surveillance by the Congress and one of its agencies. The requirements proposed by the AFL-CIO would go far beyond the requirements that the Administration and financial regulators recommend for a strengthened examinations program to advise bank management when loans are too risky and to have more disclosure for the benefit of investors and depositors. Likewise, with respect to special reserves, the AFL-CIO would also cause the banks to use part of the special reserves to share in the burden of future expansions of the IMF occasioned by the need for foreign country rescue operations occasioned, in part, by loans that they had made.

The AFL-CIO Executive Council had also recommended that private banks that have extended loans to foreign borrowers should share in the burden of any "rescue" efforts. In that connection, for the current and future efforts, I would urge the Congress to consider a proposal by a senior management officer of Barclay's Bank International which has been summarized as follows:

"Barclay's plan would allow banks to sell troublesome country loans to their central banks at a discount from face value on the condition that the money be used in new lending to support domestic—not foreign—economic recovery, such as the financing of exports. The central banks would collect on the loans as they mature, but if the debtor countries were unable to pay the loans off, the bad loans would revert to the lending bank's account, where they would ultimately be declared a loss."

Another AFL-CIO recommendation is for the Secretary of the Treasury to seek a change in IMF policies to reduce emphasis upon having aided countries develop excesses of exports over imports, and to place more emphasis upon having aided countries develop balanced domestic economic growth through development of broader domestic markets and improved income distribution. Such a policy would be helpful to the workers in the country being aided by IMF, as well as to workers in the United States.

The previous point relates to one other, final, AFL-CIO recommendation that IMF resources should not be used to reschedule and recycle the debts of totalitarian regimes and those that abuse human rights. Such regimes generally pursue economic policies that do not result in more equitable income distributions and growth of their domestic economy.

STATEMENT OF WILLIAM L. HOPPE, MANAGER OF ECONOMIC STUDIES, BETHLEHEM STEEL CORP., ON BEHALF OF AMERICAN IRON & STEEL INSTITUTE, BETHLEHEM, PA.

Mr. **Hoppe.** Mr. Chairman, my name is William L. Hoppe. I am manager of economic studies for Bethlehem Steel Corp. One of my responsibilities is to follow international economic developments as they affect world steel trade and international steel in demand.

Senator **Mathias.** Inasmuch as Bethlehem is the largest single employer in Maryland, I follow your progress with great interest.

Mr. **Hoppe.** Thank you, sir.

Senator **Mathias**. And some discouragement in recent months.

Mr. **Hoppe**. That is right.

I am testifying today on behalf of AISI. I wish I were wise enough to be able to propose a solution to some very grave problems, but I do feel that it is important in addressing the problem to keep in mind the perspective of basic industries in the United States, such as the steel industry.

There is little I can add to what has been said about the world economic situation. It is in deep crisis. A sustained recovery is vital for the whole world. Beginning in 1983, if one is to occur, the United States must be a leader, and other countries must be in a position to follow.

If the United States is to lead a sustained recovery, it is difficult to foresee such a recovery taking place if basic industries in the United States do not regain some health.

Now, let us turn for a minute to the situation in steel. The economic crisis throughout the world has greatly reduced steel demand. In the fourth quarter of last year, worldwide, the steel operating rate was at 60 percent of capacity, well below the desired rate of 85 to 90 percent. In the United States, the industry was operating at 40 percent. Our financial losses last year were $3.2 billion, and the unemployment was measured at more than 160,000.

Back in 1975, world steel growth essentially slowed down dramatically. Since that time, there has been no growth in capacity in the developed countries. On the other hand, in the developing countries, there have been ambitious expansion programs which have continued to proceed.

It would be one thing if this expansion had been minimill-type construction, facilities to build the infrastructure of those countries, but in many cases these were world class sophisticated mills financed by foreign loans and directed to serve world markets. Other than cheap labor, there is little economic rationale for building these mills where they are. They must import raw materials. The infrastructure to support those mills was not present in those countries. The markets that they serve are distant.

In other words, they are not economic facilities. They would not pass normal financial feasibility tests. Unfortunately, they have come into production at the worst possible time. Instead of helping these countries emerge from their backwardness, they are proving to be another anchor of debt weighing these countries down.

One aspect frequently not appreciated is the involvement of other foreign countries in these new steel mill facilities in the developing world. When you look at them both in terms of equipment and in terms of sources of loans for the equipment, you find that the Japanese, the Germans, French, Italians, British, and others have been deeply involved. These same countries are closing their markets to increased imports from the Third World, both in quantity and by pricing regulations.

At the same time, these other developed countries in Europe, Japan, and other places are insisting on maintaining a substantial share of the U.S. market. As far as they are concerned, where the Third World steel goes is not their problem.

If I can summarize, the U.S. steel industry, like many basic industries, is in great distress. The International Monetary Fund directive to import less and export more that they have given to the Third World *somehow gets concentrated on the U.S. market. In* 1983 to date there has been a surge of unfairly traded steel from Brazil, Mexico, Argentina, Trinidad, South Korea, and South Africa into the United States.

In light of other pressures, this hardly provides a basis for a sustained recovery within the United States. If more steel from the Third World is to come into the United States, there must be some redress. Possible solutions include, and I have got four:

First, cessation of below-market export credits, particularly for capacity additions for all countries.

Second, suspension of uneconomic and surplus steelmaking capacity now underway or planned. Even today, in Mexico, Brazil, Pakistan, new mills are being built, to further aggravate the present situation.

Third, agreement that other countries in Europe and Japan, for instance, accept equivalent amounts of steel from these countries.

And fourth, establishment of market share limits to Third World steel exports to the United States.

I would like to close with a few comments about the role of the IMF in working out the difficulties of the financial situation for the Third World. Their stance taken alone is unworkable. You might say that the Third World war is underway. Instead of being a military conflict, it has turned out to be an economic one, and one of the most badly damaged areas has been the Third World.

If we remember the lessons of World War I, we cannot expect the losing nations to make reparations to the other countries while they are rebuilding their own economic and political structure.

The problem the Third World countries face today is far greater than merely a banker's problem. It is social. It is economic. And it is political. The heads of government should be involved in developing a broad, global solution, and the interests of basic industries should be part of the many factors that they are looking at in trying to come up with that solution.

Anything less greatly endangers the possibility of an economic recovery beginning in 1983 and being sustained for a number of years. Unless we have such a recovery, there is an increased danger of a 1930-type gridlock of protectionism and economic despair.

Thank you, Mr. Chairman.

[Mr. Hoppe's prepared statement follows:]

PREPARED STATEMENT OF WILLIAM L. HOPPE

Mr. Chairman, my name is William L. Hoppe. I am Manager of Economic Studies in the Planning Department of the Bethlehem Steel Corporation. One of my responsibilities is to monitor international economic developments as they affect total steel supply and demand and international trade in steel. I am testifying today on behalf of the American Iron and Steel Institute, the trade association of the U.S. steel industry. Its membership includes 63 domestic steel companies accounting for about 90 percent of the raw steel produced in the United States. Thank you for this opportunity to testify today.

I shall comment on the present world economic situation, with particular attention to third world countries. The deterioration of the economic position of both the developed and third world countries as well as the International Monetary Fund's proposed solutions, have serious implications for the domestic steel industry. Unfortunately I do not have a full solution to offer. However, it is clear that the interest of impacted basic domestic industries like steel must be factored into the equation.

THE INTERNATIONAL ECONOMIC SITUATION

There is little that I can add to what has previously been said about the gravity of today's economic situation throughout the world. Slow or nonexistent economic growth since the second oil price shock in 1979 has created serious financial strains affecting the United States, Europe and other developed countries. The problems have been even more serious for the developing countries. With the compounding of economic and financial problems have come renewed protectionist pressures throughout the world and a dramatic slowing of world trade activity. In steel there has been one other serious effect. Capital spending throughout the world has been reduced greatly—lowering demand for steel to levels far below those considered normal.

BRIEF BACKGROUND ON STEEL INDUSTRY

Symptomatic of the steel industry's situation was its fourth quarter 1982 operating rate of about 60 percent worldwide. For the same time period the U.S. operating rate was less than 40 percent, and for all of 1982 our domestic steel industry incurred net losses of $3.2 billion. In a heavily capital intensive industry that should operate in the 85-90 percent range, the current rate of operations represents a depression level situation. Throughout the developed world—in the United States, Europe and even in Japan—expansion of steelmaking capacity has ceased. In all these countries efforts to restructure and reduce the size of existing capacity are moving ahead.

In the third world, particularly the newly industrialized countries, the situation has been dramatically different. Steel production in four Latin American countries, Taiwan and South Korea grew more than three-fold between 1970 and 1981, from 14 to 43 million net tons. (See Exhibit 1.) For the rest of the Free World during that period, steel production grew only 3 percent. In terms of growth rates, that represents a growth rate of 10.7 percent annually for the six developing countries versus a rate of only 0.3 percent annually for all the rest. Obviously this example could be made even more dramatic by selecting additional developing countries.

If third world steel expansions had concentrated on the development of small nonintegrated plants (i.e., mini-mills), producing products for construction applications that would help these countries develop their infrastructure, that would have been a constructive step. Unfortunately that is not what has happened.

In country after country, world class integrated facilities have been installed, designed to produce a broad range of sophisticated products. To a great extent these mills have been developed to serve foreign markets, and built at great expense with the aid of local government subsidies and massive foreign loans and mixed credits. A large proportion of their production must be exported.

Nor are these mills particularly economic. Other than cheap labor, there is little economic rationale for locating export oriented mills in these countries. The countries generally have to import some basic raw materials. Their economies lack the proper infrastructure to support such facilities as well as the markets to use fully the type of steel materials being produced there. These facilities would have not been built on the merits of normal financial analysis. Only on the basis of favorable government loan terms and operating subsidies are such facilities ever considered feasible.

Unfortunately, these facilities have come on stream at the worst possible time. They have not provided many jobs in comparison with the funds expended on them, nor are they proving profitable. Instead of providing a means of advancing the economic prospects of these countries they are proving to be just another anchor weighing them down. In short, as investments they have proven to be disastrous.

WHAT ABOUT THE FUTURE?

There is little to be gained bemoaning the investment errors of the past in Brazil, Mexico and other developing countries. The facilities have been built, the debts have been incurred. Some way must be found to enable these countries to work out of their present situation. But it should be within the framework of disciplines imposed by markets, rather than by further subsidies of governments, or by international financial institutions. This means that uneconomic steel expansions in these countries whose output is destined for the U.S. import market should be stopped. As we look to solutions, the financial institutions of the world should not be made whole at the expense of an already troubled steel industry in the United States. Further, the United States as a nation should not be required to shoulder an undue portion of the adjustment process. An examination of the loans made to the developing countries for new steel facilities indicates that many of the loans (and much of the equipment for the new facilities) came from Japan, France, West Germany, Great Britain and the like, and these countries should shoulder their portion of the problem they so willingly helped to create.

As long ago as in 1978 the OECD Steel Committee was formed to deal with "the problems of persistent excess capacity, an exceptionally low level of demand, unjustifiably low prices, depressed financial performance among producers and increasing governmental intervention in steel supply and demand." That represents a full plate of problems for any group to deal with. However, one of the key objectives in the OECD charter was to "avoid encouraging economically unjustified investments." Sadly, although the overcapacity situation is even more serious today than in 1978, the problem of controlling export credits for additional third world steel capacity is still being ignored. Even today new steel plants are progressing in Brazil, Mexico and Pakistan, based on the same kind of thinking that has these same countries in so much trouble.

Nor is the participation of many countries in the creation of the present steel overcapacity problem the only issue. Developed countries outside the United States stringently limit third country access to their steel markets. The United States is the only major developed country market open to third world steel imports.

Let's consider Brazil as an example. There is little question that Brazilian exports are uneconomic and government subsidized. In the last year Brazil has been the target of steel trade cases in the United States and the EEC. In both cases it was found guilty. The difference is that as a result of the cases, the United States gave Brazil a mild slap on the wrist, agreeing to an export tax collected by the Brazilian Government which continues to subsidize steel exports to the United States. Since then imports from Brazil have increased. On the other hand the Europeans have applied a 15 percent antidumping duty on key Brazilian steel products. You can be sure that Brazilian exports to the EEC will be carefully limited in the years ahead. In addition, Australia, Canada, and Japan have all taken action to put Brazil and other countries "on notice" that they will not permit rapidly rising steel imports from them. All this has the effect of translating part of an international financial problem into a steel overcapacity problem and then further into a problem directed primarily at the U.S. market.

Meanwhile, the Europeans, the Japanese and others whose own home markets are carefully limited, are most adamant about maintaining their "rightful share" of steel mill product imports into the United States.

Let me summarize the most important aspects of our present situation. The financial condition of the U.S. steel industry is rapidly deteriorating—in 1982 losses from steel operations were $3.2 billion. As a result, our capital expenditure programs over several ensuing years are being reduced dramatically. Our ability to revive these plans and provide for the future modernization of the domestic steel industry is in serious jeopardy. Our modernization will be almost impossible if developed countries insist on maintaining their market share in the United States while at the same time closing their own home markets to steel products from the Third World countries—whose excess output will then be directed solely to the United States. U.S. trade laws, which are only nominally enforced, are cold comfort against the realities of the accommodations that must be made to help various developing countries out of their present distress. On the other hand, the domestic steel industry is hardly in a position to endure the consequences of increased unfair trade from the Third World without some redress. Solutions must include:

1. Cessation of below market export credits, and particularly those directed at capacity additions, from all countries;
2. Suspension of uneconomic and surplus capacity expansion now underway or being planned;
3. Agreement that other countries accept equivalent amounts of steel from these countries; and
4. Establishment of market share limits to third world steel exports to the United States.

WHAT ROLE SHOULD THE IMF PLAY IN PRESENT SITUATION?

That brings me to the separate issue of the role that the IMF should play in the present situation.

In reality, as one looks at the present world situation, one might say the Third World War is already underway. Instead of a military conflict, it is economic—its primary effect so far has been on the developing countries and on the basic industries of the United States. The present indebtedness of the developing countries is beyond their likely ability to make reparation payments.

Within the world war analogy, we should keep in mind the lesson learned after WWI. We can't expect the "losing" nations to pay off all their debts while addressing critical social and political problems needing attention at home.

The same can be said for the developing nations today. We can't ask them to "import less and export more" while paying down their debts and expect either their economies—or the world economy—to regain vitality during the process. Yet a sustained worldwide economic recovery beginning in 1983 is of critical importance for everyone. It must be led by the United States, however, and it will not get underway until the basic industries of the United States regain their strength.

Today's situation with Third World debt represents far more than a financial problem to be handled by the IMF. It has serious social, economic, trade and Third World recovery ramifications as well. Heads of government, rather than the IMF, should be directing efforts to develop an equitable resolution of these problems. However, such resolution must recognize the need to pare back overly ambitious and uneconomic ventures which only serve to exacerbate worldwide overcapacity problems.

There is little margin for either error or delay. Without moving ahead to find a truly visionary solution—developing a way for sustained economic growth throughout the Free World—today's financial problems may well snowball into a 1930's type grid lock of protectionism and economic despair. That would not be in anyone's best interests.

Thank you.

EXHIBIT 1.—COMPARISON OF INDEBTEDNESS AND STEEL PRODUCTION, SELECTED COUNTRIES

	Total debt Dec. 31, 1982 (billions)	Raw steel production—Million net tons		
		1970	1981	1970–81 (percent increase)
Brazil	$87	5.9	14.5	146
Mexico	80	4.3	8.4	95
Argentina	43	2.0	2.8	40
South Korea	36	.5	11.9	2,280
Venezuela	28	1.0	2.2	120
Taiwan	([1])	.4	3.5	775
Total above		14.1	43.3	207
Steel production—Rest of Free World:				
United States		131.5	119.9	(9)
EEC (9)		151.7	138.2	(9)
Japan		102.9	112.1	9
All other		62.0	93.0	50
Rest of Free World		448.1	463.2	3

[1] Not available.

Source: International Iron & Steel Institute.

Senator **Mathias**. Thank you, Mr. Hoppe.

I think you have both maintained the traditions of this series of hearings in being relatively pessimistic about the problem and about the magnitude of the problem and the urgency of it. I am interested that both of you agree that the policy of the IMF in discouraging imports by developing nations and encouraging exports ought to be altered, and it might be a good place to start our discussion, because it seems to me that is a very critical point.

If the developing countries are to maintain debt service in the immediate future, let alone ultimately pay back some of the principal on these loans, they are going to have to go out and earn hard currency somewhere. Let me be the devil's advocate here for a moment and ask you how you think they are going to be able to earn the hard currency to service the loans if they are not selling in world markets.

Mr. SCHECHTER. They undoubtedly have to sell on world markets, but they are at the same time, by following the policies which are generally required by the IMF, including domestic policies, they are creating in their own economy an unbalanced economy.

That is, those who have to work to earn a living have their resources reduced, particularly on the budgetary policy side, and to the extent that the export products really are designed for the other countries, what I am getting at is, there is no condition requiring the countries in their domestic economy to pay attention to their income distribution.

In the United States, we grew to a very great economy at a time when our exports were a relatively small part of our economy, because we had a balanced economy as we went along, especially, I would say, in the last 100 years, when we became an industrial nation, whereas to follow the precepts of what I would call a banker's policy, which is the type of conditions that are laid down, is not to broaden the domestic markets of those countries.

If they broadened the domestic markets and had a balanced growth and could grow, then, to the extent that they grew, they could, of course, export some more also, but they would have more of a market that we could export to, and the balance internationally would come about more readily.

Senator MATHIAS. Mr. Hoppe, do you want to comment on that?

Mr. HOPPE. Yes; I would say there are two basic considerations there.

First, the debt that the Third World countries has today includes to a certain extent some very bad loans and some exorbitant interest rates that have compounded over a number of years. To put all this burden on these countries in the present world situation puts them in a box that is very hard for them to get out of under any circumstances.

So, perhaps some way of getting relief is fundamental. You just cannot put it all on them and say, OK, now go ahead.

Second, I am deeply concerned that as solutions are developed that the United States becomes the beginning and the end of the rescue package. Somehow, the whole world has got to be involved in this situation, and it cannot be, OK, the United States is the big market. We are the ones that must accept the burden for everybody.

Senator MATHIAS. Well, I agree with that, but as you yourself said in your statement, today's situation has serious socioeconomic trade and Third World economic recovery implications, and that, of course, is the complexity of the situation with which we have to deal.

Let me ask you both this question. Do you believe that the IMF has too much influence on these governments? Mr. Hoppe, you said that heads of governments should be involved. Is not the way the situation works to have the IMF make recommendations to heads of government? The IMF cannot dictate. Mr. Schechter is shaking his head there.

Mr. SCHECHTER. When somebody knows that it either accepts the IMF conditions or else face technical default, which means no credit for a long time. I think it is very close to being dictated to.

Senator MATHIAS. But the President of Mexico or the President of Brazil or Argentina must as a political act accept the recommendations or at least work with the IMF in developing a program.

Mr. SCHECHTER. Sure. He has no choice, and therefore he has no choice in accepting some pretty tough conditions which are laid down by IMF, and at the same time, the irony is that the banks can levy these rather substantial fees for rescheduling the debt where if it were not for the IMF contribution, there would be no rescheduling. There would be a default.

So, on loans which were made which were probably too risky to start with, with the rescue of the IMF, the banks still levy a fee for rescheduling, and that, of course, increases the burden and makes it harder for the whole situation to work out.

Mr. HOPPE. Within our own Government, I would say that an IMF-type solution would probably be worked out between or in consultation with Treasury and perhaps the State Department, but I would also think that these solutions have grave implications in trade, and USTR and Commerce should have some input and some ability to say, here are some of the problems that a proposed solution might be developing which have implications far broader than Treasury officials might initially consider.

Senator MATHIAS. Well, we are talking about two things. One, the substantive kinds of conditions that IMF lays down, and second, how they work. On the second point, what about the problem that many governments have that financial or economic disciplinary measures are not very popular politically, and that it takes some external force to make it feasible for a government, particularly a weak and relatively unstable government, to tighten the belt.

The most necessary partner in a law firm is the evil partner. The good partners will all make a settlement, reach a compromise, negotiate a solution to any problem, but their evil partner prevents them from doing it.

Is the IMF the necessary evil partner in these transactions?

Mr. SCHECHTER. Sure, the IMF has to play that role to some extent, but I believe that the IMF role becomes even more harsh because it pursues policies—it wants the aided countries to pursue policies which are accepted in, let us say, countries like the United States; on the other hand, ignoring policies which some of our more successful trading partners have used, such as Japan, for example.

One of the reasons Japan has been so successful in international trade is the fact that they have regulated, let us say, their own financial house, primarily the interest rate levels, by using credit controls from time to time very successfully.

Senator MATHIAS. Not to mention their exchange rate level.

Mr. SCHECHTER. Well, that is a product of it, because during the years—I have in my testimony a couple of tables, I believe.

Senator MATHIAS. They are very interesting tables.

Mr. SCHECHTER. And they will show you that during the years when we have very high interest rates, Japan managed to have very low interest rates. They use, from time to time, the type of credit control that we used for just about 3 months in 1980 and brought our interest rates down very rapidly temporary, and got a pickup in the economy.

Because of that, of course, they did have an outflow of funds, and we got some of the inflow, and the Fed had to tighten up even more to guard against those effects. So, what we have here is, we and most of the developed countries are wedded to simply what I would call a fairly strict monetarist policy. Tight money is the solution. That is the discipline we force upon ourselves. Perhaps it is not the best route to go. It certainly gave us a prolonged recession, and a great deal of unemployment, and loss of capital formation, and so on.

But the IMF has not taken the leaf from the Japanese policies, which have been more successful than ours, and so it is not just a question of bringing discipline, but what sort of techniques are used and what sort of techniques are forced upon the other countries.

Mr. HOPPE. If I might comment, I would like to go back to the world war reparations analogy for a moment. I think to look at the present Third World debt situation, and to lay all the blame on the Third World is a pretty heavy verdict. I surprise myself. I think I sound liberal or something. But the banks were pushing the money——

Senator MATHIAS. That is not all bad.

Mr. HOPPE. The banks were pushing the funds out. The currency exchange rates went crazy. The interest rates went crazy. And some of the loans, some of the projects were just poorly conceived, but not just by those developing countries. When the whole world is in economic crises, and there are no good, strong sectors of the world that can carry the load while this adjustment process is going on, it is somewhat unrealistic to turn to these countries and say, OK, you must take all the medicine. You must get yourselves, your houses back in order, without disrupting the rest of the world economy. I think that the IMF needs to consult with other wise heads with broader vision in working out the solutions.

I commend the kind of piece that Helmut Schmidt recently put together in the Economist and other papers throughout the world on his view of what must be done in this situation.

Senator MATHIAS. Now you are beginning to sound liberal, endorsing a socialist doctrine. But you talk about the Third World countries having to carry the load themselves. Mr. Schechter in his paper recommended that the private banks who have extended loans to foreign borrowers should share the burden of the rescue.

Let me say that there has never been any suggestion that the private sector in the developed world would not share the burden. All of the burden of the testimony that has been before this committee in the seven hearings that we have had, the six preceding hearings, has been that the private sector would have to be very much involved, not only to the extent of maintaining the loans that are now outstanding, but increasing them at the rate of about 7 percent a year, and that without that increased participation by the banks of the developed countries, without that, the rescue effort would fail. The IMF alone cannot pull this off.

Mr. Schechter.

Mr. Schechter. Sure, I agree. The IMF has also induced the banks to continue to extend further loans to keep the thing going, but it is the $15 billion of U.S. Treasury capital that would be out there—about $6.5 billion now—not earning any return, of course, and the banks have never sacrificed return, so I would say they have not contributed to the same extent that the government has contributed.

And, you know, this is supposed to be, I suppose, a world partnership for the good of the world. Nevertheless, here are the people who are charging interest rates which are supposed to reflect the risk, and the thing would not work without thus far the approximately $7 billion of U.S. money that is in the IMF funds and the additional $8.5 billion which I believe will be drawn down very soon because of the crises.

So, I do not see that they have contributed. They have what is practically a backup of the IMF in the U.S. Treasury and other treasuries which protects them, because as more time is needed for rescheduling, we get an additional IMF expansion, and more IMF funds from governments. I think if the banks were really made to absorb some of the costs, even if it were interest, not interest-bearing reserves that they had to set aside, that would perhaps make them exhibit more of their so-called vaunted or characteristic prudence which bankers are supposed to have. And I think some like that is needed.

Senator Mathias. Of course, this becomes a judgmental matter, as this whole business is. If you press the banks too far, little banks, and we are talking now not about Chase Manhattan, Citicorp, or Morgan Guaranty, we are talking about 1,500 banks in the United States, many of them regional banks, scattered around the country, and many of whom must be very tempted just to get out of the whole business, just to write off whatever they have got outstanding today and forget about it.

So, where is the point at which that happens in a significant volume and brings about really the practical withdrawal of the private sector?

Mr. Schechter. I think bankers understand the need for reserves. Of course, you make a very correct differentiation. The bank that has half a billion in foreign loans, it has a problem, not just the debtor, so they will not get out.

Senator Mathias. That has become a marriage.

Mr. Schechter. Yes; but those who have only $10 million because they have participated with their correspondent larger bank, would be inclined to get out, and perhaps it would be a good thing if they got out. We would have to find a way of making up for it. The bigger banks might have to come in for more for a while. But the bank that just participates with $10 million really does not examine very carefully. It is because Chase or Bank of America or somebody else is doing it that, well, we will put $2 million in also.

And I do not think that is the way that banking should be conducted, and then rely upon Government assistance, both from our FDIC, which last year had to close 42 banks and contribute, and this year thus far has 14 already. So, I think what we need is a return to what I would call sound banking again on the international front.

Senator **Mathias**. Now Mr. Schechter is sounding like the conservative.

Mr. **Schechter**. Well, I think the labor movement is always conservative.

Mr. **Hoppe**. If I could comment on this issue, the thing that I find annoying is that after the banks have made badly conceived loans for something like steelmaking facilities, there is great pressure for the bank community to be made whole. As a result, the bad loan problem becomes a steel capacity problem. The financial crisis may be resolved but the capacity remains there.

It is uneconomic. Steel from it is unfairly traded if it enters the world market, and it becomes the domestic steel industry's problem. We have a whole raft of problems that we are facing without this one being added onto us, a problem over which we have very little control.

Senator **Mathias**. But you are suggesting a control over our economy that would be beyond anything we have ever experienced. Let us get down to the real hypothetical cases. There is not any city in the country that has more interest in the steel industry than Baltimore, I do not think. Thousands of jobs depend on it. Activities in the Port of Baltimore depend on it. Activities of the railroads depend on bringing in coal. A whole myriad of activities in Baltimore depend on it.

But are you saying that the First National Bank or the Maryland National Bank or some other bank considers a loan to some foreign country that has an element of investment in steel in it, that they should forego that loan?

Mr. **Hoppe**. I am saying at present there is a great overcapacity throughout the world, that today, as——

Senator **Mathias**. In our hypothetical case, let us say there is not an overcapacity in the world, but that this clearly, if they finance a new steel plant in Taiwan or Korea, is going to be ultimately competitive with Sparrow's Point. Should they not do that?

Mr. **Hoppe**. What we ideally want is to have the markets control what is going on, and unfortunately today we do not have the markets controlling what is going on, and that is the reason for our crisis. There is government ownership. There are all these other——

Senator **Mathias**. But maybe the markets do control it, but people do not perceive the markets correctly. Now, both of you have suggested that it was bad judgment to view the seventies as a time in which they should have been making these big loans to the developing world, that the banks should make these loans to the developing world.

Perhaps the same type of misperception applies to the steel industry. Again, I am being the devil's advocate here. But did the world look good enough toward the end of the seventies in terms of steel markets to encourage these developments?

Mr. **Hoppe**. We stopped growing—we testified in 1978 and 1979 to Congress. We talked to the World Bank, you are making a big mistake in making such loans. They did not look like good loans to us. But there was very little interest in what we had to say. Today, these facilities come on stream and flounder. More facilities are still being built, and more export credit loans are being made to these Third World countries by other countries.

You know, today the Russians are building a mill in Pakistan. That is not to serve the red bloc. It is designed to make sheet mill products. Those are not going to be used in Pakistan. But what do the Russians have to lose? Maybe this is part of their grand scheme to keep destabilizing the free world. Somehow such developments keep piling in on us, while every other country wants to maintain its share of the U.S. steel market.

And so the market force has just been obviated by these other problems at the present.

Senator MATHIAS. Mr. Schechter.

Mr. SCHECHTER. Mr. Chairman, I would agree with my colleague at least partly. Certainly the other countries have set up special financing mechanisms of their own which subsidizes their operations. Japan has national development banks which make long-term loans to industries they want to develop at below market rates.

As has been mentioned, I think the Germans and the French when they sell equipment sell with subsidized interest rates. We do a little of that for our Export-Import Bank, but we are amateurs compared to others, and so we are not talking about a free market around the world.

We are talking about a market which is tailored from the various countries that want to take advantage of it. Now, there are other reasons, I think, besides the cheap labor, although that is a very important reason that some of these other plants have been built in developing countries, but they do, they can adopt the latest technology, which gives them a certain advantage, that plus the financing, plus more protectionism which already exists in other countries which will not let products in from our country.

I think all of this put together means that we, if we are to remain a viable economy, and be a big market for the world, then we have to start organizing. Yes, it is not going to be what we now call free enterprise. It will mean that perhaps we give guidance to capital to priority areas as other countries do.

Otherwise, if we do not take some of these measures, then our economy gets weaker, and if we get weaker, the rest of the world is not going to benefit from that. They are going to suffer from it, as we saw during the last 2 years.

So, I think, to be realistic, we have to start examining these details of what brings the other plants into production, and enables them to sell steel at a much lower rate.

Senator MATHIAS. Of course, Mr. Hoppe's point, as I understand it, is there ought to be some point at which you could make an economic judgment as to what was or was not the development or a direction in which we should move our economy and consequently the world economy, but I must confess to you that I am pessimistic about who would make that decision.

Mr. SCHECHTER. The AFL–CIO and some others have been suggesting reestablishment of the old Reconstruction Finance Corporation [RFC] idea, and when that actually operated, the man brought in to run it was Jesse Jones, the Texas banker, and he had some savvy, and there were loans made to all sorts of industries. The

B&O Railroad was helped. It is now part of the Chessie System, but that was in danger of going under. It did not.

There was a lack of aluminum producing capacity. At that time we had only Alcoa. Reynolds Metals was started with RFC loans. So, this was government, but I think it played a very positive role.

Senator MATHIAS. That loan to the B&O Railroad had an interesting byproduct. They took as security, the old C&O Canal, and then when the railroad defaulted, the Government ended up with a canal which is now, I think, an outstanding national park property.

Mr. SCHECHTER. We saved a park.

Senator MATHIAS. So everybody benefited. But the difficulty is, there are not that many Jesse Joneses around the world, and when you leave this to the private sector, the private sector is capable of making mistakes, as you both pointed out, because the volume of loans to the developing world is probably larger than the economics of the situation justify.

If you put it in the hands of government, the same kinds of mistakes are made. I can recall some years ago we loaned some money to the Argentines to build a beef processing plant, and about the time the plant was completed, the beef industry in the United States woke up to the fact that during hard times for them, they were about to have a huge new competitor financed by the U.S. Government, and so the same kinds of mistakes are made at the governmental level.

Mr. SCHECHTER. I think if we can get a melding of interests really so it does not have to be just the Government or just the lender who makes the decision, but I think if we had government, industry, and labor having input into whatever you want to call it, a policy board or something like that, we could protect ourselves against a one-sided view, you know, the man who touches one side of the elephant. To some extent, we can perhaps come up with better decisions.

Senator MATHIAS. You both suggested that there ought to be a greater amount of information about foreign loans available within the U.S. financial community, and I heartily concur with that. I would like to see a requirement that banks do report on a regular basis and on a timely basis, not a year or two after the fact, but concurrently with the actual making of the loans, so that the Treasury and ultimately the IMF itself could at least monitor the volume of this business, if not the individual transactions.

Mr. SCHECHTER. And as I indicated, I would like to see the regular reports, as the Federal Reserve is now supposed to do on the money supply, to the appropriate committees of the Congress, because with all due respect to our regulators, you know, they become a little friendly with the people they regulate, and so it would be desirable, I think, to have reports to the oversight committees of Congress.

Senator MATHIAS. I agree with that.

Mr. HOPPE. Keeping this on the global scale, back in 1978 the OECD Steel Committee was formed. One of the purposes of that Steel Committee was to stop export credits at below market rates, and one of the charges given to the committee was to get a listing of what kind of credits were being given by which countries for new steel facilities around the world. In 1983, that list still does not exist, because these governments just find it very difficult to put on the table what they are doing in the rest of the world.

Senator MATHIAS. Well, that brings me to the second point. It may be in addition to increased access to financial reports there ought to be increased access to a number of economic reports on a global basis, so that there can be the kind of realistic assessment of the steel industry or any other given industry.

Mr. SCHECHTER. It is a difficult problem, but I can see then that if we in effect start exercising certain amounts of control, let us say, over the productive capacity around the world, then I think that is done with the approval and blessing of the U.S. Government. Then the U.S. Government must enter into the decisions all the time.

Senator MATHIAS. I am not suggesting we assume control. I am just talking about a greater flow of information so that an assessment can be made as to market potential and resource potentials in the world economy. Now, the control for any economic unit, any national unit would have to be with the government of that country, but bankers elsewhere, including the IMF, would then have some realistic yardsticks.

Mr. SCHECHTER. Of course, the IMF has come in after the fact generally.

Senator MATHIAS. That is right, and that is what it is designed to do, is to come in when there is a problem.

Mr. SCHECHTER. Well, then, I guess the idea is perhaps private bankers will pay more attention if there is more information available. I always assume that before they make multimillion dollar loans they would explore it thoroughly, but I suppose maybe they do not.

Senator MATHIAS. We would hope they did, but if the figures are laid out there in front of them, they would have a greater responsibility. Mr. Schechter, you made an interesting remark. You say large amounts of financial capital from OPEC countries along with U.S.-generated capital was placed in high-risk foreign loans, decreasing the supply and raising the cost of capital for domestic investment.

Of course, that is one of the objections that is made to the increased quotas for IMF, that it is decreasing the availability of capital. But I am wondering on what you base that judgment, because there is a belief in some quarters that at least a part, perhaps a sizable part of the OPEC surplus has ended up in the Eurodollar market, and that in turn was funneled into lending to developed countries.

Mr. SCHECHTER. Yes; there is no doubt a good part of it ended up in the Eurodollar market, but to the extent that our banks were the recyclers, they were able to export a good deal of it to other countries.

Senator MATHIAS. But that is not U.S.-generated capital.

Mr. SCHECHTER. No; but the fact is that our banks had the duty, if you will, of investing it, and they chose in many instances to invest it overseas, and of course money is fungible. I cannot distinguish between domestically created funds and OPEC funds, but they were putting increasing amounts of capital overseas.

Senator MATHIAS. But there was sizable foreign lending.

Mr. SCHECHTER. Yes, sure.

Senator MATHIAS. That did funnel through U.S. banks?

Mr. SCHECHTER. Yes.

Senator MATHIAS. And to the extent that that stimulated trade, did it not also stimulate exports and jobs in this country?

Mr. SCHECHTER. In many cases, it led to a decline of jobs in this country. For example, many of our own multinational companies just picked up entire plants and moved them overseas to developing country areas with financing from banks and other sources, sometimes internal financing, and that may in some instances have created jobs, but a lot of the steel industry difficulties and some of the finished product difficulties result from that.

An example that received some publicity a few months ago when General Electric closed down a couple of clothing ironing plants, one in Schenectady, I think, and one some place else, and placed one in Singapore, they are always double sourced to make sure they will have their overseas supplies, and one some place else in the Third World. Now, that meant that employment was lost to the United States, and in time that will mean that the United States as a market for goods from all the other countries is growing smaller.

Now, the multinationals really are not too much concerned with that. They are going over after that big wide market all over the world, including China, India, and so on. So they have no concern, really, I think, with the economy of the United States when they do that, but I think the rest of us should have that concern.

Senator MATHIAS. You responded with some vigor on the subject of exporting jobs. I suspect you have a paper somewhere on that subject.

Mr. SCHECHTER. We have numbers put together.

Senator MATHIAS. It is a little off the subject of today's hearings, but if you have something that you could conveniently let us have.

Mr. SCHECHTER. I will be glad to.

[The information referred to follows:]

STEEL MANUFACTURING

In 1982, U.S. imports of steel mill products rose to a record high of 22.3 percent of apparent supply. Market penetration by imports had been only 2.3 percent in the 1950's and rose steadily since then. Total imports in 1982 were 16,663,000 tons, equal to 22.3 percent of apparent supply. The difference between 22.3 percent and the 2.3 percent of the 1950's, or 20 percent, or 15,168,000 tons can be considered the amount of foreign steel imports that displaced domestic steel. On the basis of 5,000 jobs required to produce 1 million tons of steel, the 1982 imports led to the export of 83,315 jobs.

AUTO MANUFACTURING

Between 1968 and 1982, the market share of new car sales in the United States accounted for by Japanese imports increased from 1.2 to 22.6 percent. If that increase in the Japanese share had not taken place, in 1982, the domestic make U.S. car sales, and presumably production, would have been about 30 percent greater. Direct auto employment would then be about 884,000 instead of 680,000. Furthermore, employment in the supplier industries (estimated by the Bureau of Labor Statistics as 2.36 jobs for every job in the vehicle companies) would have been greater by 481,000. The total job loss due to the Japanese car import increase since 1968, therefore, is about 685,000. Only fragmentary data are readily available on the long-run penetration of the U.S. market by European cars, and, as a rough guess, their impact would probably be about one-fourth that of the Japanese imports.

OTHER INDUSTRIES

There are, no doubt, other foreign product imports—in textiles, apparel, shoes, electronics, television and radio sets, machine tools, optics, etc.—which would add up to additional hundreds of thousands of job losses.

Senator MATHIAS. It is something I am very much interested in, to see what the net effect is. Just to cite two industries, steel and autos, we know it has been a tremendous amount.

To get back to a subject of this morning, I gather that the AFL-CIO supports the increased quotas for the IMF.

Mr. SCHECHTER. With conditions we have made.

Senator MATHIAS. With the conditions you have enunciated.

Mr. SCHECHTER. Yes.

Senator MATHIAS. How about the Iron & Steel Institute?

Mr. HOPPE. We certainly feel that that is a necessary first step.

Senator MATHIAS. With the conditions.

Mr. HOPPE. With conditions.

Senator MATHIAS. But then conditionally you support the increase.

Mr. HOPPE. That is correct. The last thing we can do is grind these countries down, just wipe them out.

Senator MATHIAS. Well, that anticipates my next question. Is it big enough? Is it sufficient to meet the likely needs should the recession be longer than people think it is going to be? I mean, there is a kind of implicit hope in this that here we are going to pass this quota and everything is going to be all right. I do not have that sense myself, but what do you think?

Mr. HOPPE. My guess would be that it is not large enough, because just the very terms of what they are considering I feel will have an undermining effect to the recovery in the U.S. economy. Any weakening in the U.S. recovery holds back the whole world recovery. Then we get into a half-solution that is not a solution.

Senator MATHIAS. I think that is clear, that as we dampen down the imports by developing nations, we are restricting our own economic recovery.

Mr. SCHECHTER. I would agree with that, but in addition, the reason I am pessimistic about a sustained economic recovery is that in our domestic economic management, we have adopted no new tools, really, so that unless we do something to change our own economic policy, the recovery of the United States will not be vigorous enough to help the countries, the developing countries of the world.

Senator MATHIAS. I would assume from what you both say that you would agree, then, that the banks have to stay in. If the IMF quotas are marginally sufficient, they clearly would be insufficient if there was any large-scale withdrawal by the private sector from this area.

Mr. HOPPE. This would not be the first time that the banks had all looked at each other in the eye and said, we are in it and we have got to stay. And I think that is where they are.

Senator MATHIAS. And that is where they have to be.

This is again a little beyond the scope of this hearing, but Mr. Schechter has tempted me into it. We have had an impressive series of advertisements that a group of national leaders have sponsored recently urging the President to take steps to drastically reduce the projected deficits, and suggesting that we cannot get economic growth without some new structural changes.

What is going to be the impact on the economy if the President fails to take those steps?

Mr. SCHECHTER. Well, it depends which steps. For example, I think if we began to recapture some of the taxes that were cut in the 1981 Tax Act, and if it were done selectively—for example, we have been advocating capping the July 1 reduction, the third phase of the tax cut, for persons to $700 per taxpayer, which would mean households with incomes over $41,000, $42,000, something like that, would not get more than $700. Instead of getting a $2,500 reduction, they would get only $700.

I think this really would have very little adverse effect upon purchasing power, because the people with the upper incomes have a lower propensity to consume when it gets to the upper level of their income, whereas those at the lower level do not, and we could use the—I think it would be $6 or $7 billion in revenue in the first full year, fiscal year 1984, and then more in subsequent years.

We would also like to see the elimination of the indexing so that we begin to remove some of the deficit that is facing us.

Another thing we have been advocating is to restore the Credit Control Act, and as it is right now, with inflation at practically zero—well, it has been negative a couple of months, and during the last 6 months I think it was something like 1 percent. We have a prime interest rate of 10 percent and so on. So what we need is something to bring down interest rates, which of course is costing us—the debt service on the Federal debt is now about $100 billion a year, and it could be reduced greatly if we had lower interest rates.

So, yes, I think we can reduce the deficits. I would not advocate cutting back on the social programs more than they have been cut back, because there we are detracting from demand. We know every dollar of aid represented in that assistance becomes consumer demand in the economy, and we still have more than 10 percent unemployment, and we are still in a fairly serious recession. We need to get the economy moving upward, while at the same time reducing the deficit, and I think if we do it selectively we can do it.

Mr. HOPPE. I have to disagree with my associate's comments about the tax programs. I really feel that whether it is eliminating future tax cuts or raising taxes, whichever way you look at it, altering the present personal tax is a poor way under the present circumstances to revitalize our economy. I do have to agree that the budget deficit must be reduced. Social programs are difficult to cut any more. Defense is one of the areas where there must be some reduction. On the other hand, just resuming sustained economic growth will provide the most important means of closing the existing deficit.

Senator MATHIAS. Well, this is, of course, vitally connected to managing the world debt problem. I have looked at it very hard, and I must confess I do not find any other way to go than to forego the July tax cut and to repeal indexing. By 1988, that produces $80 billion, and that is the only sizable amount of money you can get your hands on. There just is not any other place for it to come from. That is the only solution, and I am a little tougher than Mr. Schechter. I think we might as well just forget the July tax cut. If you start capping it, or you fiddle around with it, it is expensive and you do not really do much in the way of social equity.

The benefits of the cut are weighted so heavily toward the higher income part of the economy. It is a terribly tough problem, and I think that is a major part of our challenge, but those are decisions that are lying just ahead of us. They are going to be very tough ones. Congress will walk across the burning sands in the months ahead.

But I am very grateful to you both for your testimony this morning, and I think this record would not have been complete without what each of you have had to say. I am very grateful for it. Thank you very much.

At the request of the Foreign Relations Committee the Congressional Research Service has prepared a study entitled "U.S. Policy Options on Polish Sanctions." Since this study includes an analysis of the Polish debt situation I ask that it be included in the record of this hearing.[1]

The committee will stand in adjournment, subject to the call of the Chair.

[Whereupon, at 12:14 p.m., the subcommittee adjourned, subject to call of the Chair.]

---

[1] See page 546.

APPENDIX

United States Senate,
Committee on Foreign Relations,
Washington, D.C., December 28, 1982.

Memorandum to: Members of the Committee on Foreign Relations.
Thru: Ed Sanders and Jerry Christianson.
From: Cas Yost, Joel Johnson, Janice O'Connell, and Gerald E. Connolly.
Re: Hearings on the International Financial System.

INTRODUCTION

The Subcommittee on International Economic Policy will hold a series of six hearings in January and February 1983 on the stresses and strains in the International Financial System. These hearings are intended to form the basis for Committee consideration of any Administration requests for additional funding authorizations for the IMF and Multilateral Development Banks in 1983.

The following hearings have been scheduled: January 10 (10 a.m.)—Global Economic Outlook; January 10 (2 p.m.)—LDC Needs and Prospects; January 19 (10 a.m.)—Global Debt; and February 1 (10 a.m.)—Recommendations for the Future.

Additional hearings with Secretary of State Schultz and Secretary of Treasury Regan on the topic "The International Economy and National Security" will be scheduled for later in February.

This memo covers the issues for the first hearing on January 10, in Room 4221 Dirksen Senate Office Building at 10 a.m. Senator Mathias will preside. Witnesses include: The Honorable Henry H. Fowler, Chairman, Goldman Sachs International Corp.; The Honorable Charles Shultze, Visiting Professor of Research, Stanford University; The Honorable W. Michael Blumenthal, Chairman and Chief Executive Officer, Burroughs Corporation.

SUMMARY

The global economy is gripped by a severe recession. Despite declining energy costs, reductions in U.S. inflation and nominal interest rates, and the recent reduction in the value of the dollar, industrial countries continue to experience high unemployment, large budget deficits, a disturbing number of business failures, and serious underutilization of industrial capacity. Economic growth in the West has been stagnant. Many LDCs are faced with servicing massive external debts at a time of greatly reduced demand and prices for their exports. The political costs of forced economic retrenchment threaten, in some cases, to be severe. The global economy generally must face the inter-related problems of debt which can't be serviced, substantial exchange rate fluctuations, and stagnant world trade which is increasingly threatened by growing protectionist pressures.

GENERAL ECONOMIC CONDITIONS

In the last decade the global economy has been plagued by successive bouts of inflation, high and growing unemployment, sluggish private investment and sizable increases in real energy costs (in 1973 and 1979).

In 1980 the industrial West entered into a period of recession from which it (and the world economy) have yet to emerge. World trade has declined in volume for the first time in the post-World War II period. The OECD is predicting 34 million unemployed in member countries in 1984, up from 25.4 million in 1981. The United States is facing post-depression records for unemployment and business failures and declining farm income. We are also laboring under record budget deficits. Approximately 30 percent of our factory capacity lies idle. The United States faces mounting trade and current account deficits with some predicting $100 billion and $40 billion respectively in 1983.

These problems are also being experienced in Europe where many countries face their third straight year of zero or low economic growth. Their problems are relatively greater given European dependence on the export sector of their economies.

The LDCs also suffer heightened economic difficulties due to the recession in the West and the restrictive monetary policies being pursued in order to deal with this recession. Between the end of 1979 and August 1982 commodity prices fell by approximately 30 percent. They are, at present, at their lowest point in a generation, reflecting greatly reduced global demand for primary exports.

A particular problem is being faced by oil exporting LDCs, such as Nigeria and Mexico, whose economic growth has been based on petroleum export earnings. These countries have been hurt by the drop in global energy demand and the resulting decline in oil revenues. They would be hurt still further by the precipitous drop in oil prices some observers are predicting. Some analysts question whether the global economy would benefit in general from a significant drop in energy costs. They argue this would not only harm a number of energy exporters but would further reduce the size of surplus OPEC funds which until now have been recycled to meet global financial liquidity constraints. Moreover, they believe that reduced energy costs may have an adverse impact on the search for alternate energy sources in the West.

In any case, the LDCs must service a debt burden which in aggregate is estimated (medium and long term) to be over $500 billion in 1982. Their ability to service this debt is made more difficult by a hesitancy among certain commercial banks to advance additional funds or roll over existing debt as it comes due. The much publicized problems of Mexico, Argentina, and Brazil (which together have about $200 billion of the debt) have excited fears in the market place with respect to the overexposure of many of the largest commercial banks to weak economies.

In this atmosphere questions are being raised about the capacity of the existing institutions—national and multinational—to cope with these problems. Some observers point to the gap between the long term lending efforts of the World Bank and the short term balance of payments adjustment approach of the IMF. Concerns are also raised with respect to the relatively unregulated nature of commercial bank sovereign risk lending.

U.S. POSITION

In the past the U.S. economy has been the engine of economic recovery in times of economic stagnation elsewhere in the world. This may still prove to be the case, but it is also increasingly evident that U.S. economic prosperity is linked to economic growth in other countries.

Exports currently account for approximately 10 percent of U.S. GNP, more than double ten years ago. Twenty percent of U.S. industrial output is exported. One of every six U.S. workers in the manufacturing sector produces for export. Significantly, between 1977 and 1980 four out of every five new jobs created in the U.S. manufacturing sector were export related. In addition, two out of every five acres of U.S. farmland produce for export. Finally, approximately a third of all U.S. corporate profits come from companies' international activities.

The United States, in short, has developed a very sizable stake in the global economy. Moreover, it's stake in LDC markets is particularly important. At present the United States sells more to the developing world than to Japan and the EEC combined. Our third largest trading partner, at present, is Mexico. Reduced Mexican imports are inevitably going to be felt in the U.S. domestic economy.

SPECIFIC ISSUES

Three problem areas need to be expanded upon: debt, exchange rate fluctuations, and trade restrictions. Alone and in combination they can significantly exacerbate economic problems.

Debt.—As noted above, there is about $500 billion in cumulative (medium and long term) debt outstanding to non-OPEC LDCs. This is up from $100 billion a decade ago and reflects accelerated lending by commercial banks in the 1970's and early 1980's. Indeed, the commercial bank portion of this debt has risen from approximately 45 percent in 1973 to 65 percent at present.

There are those who maintained that commercial banks over-extended themselves at a time of significant economic growth in the LDCs and when OPEC surplus funds were available for recycling.

In any case, the IMF has noted that "in 1975 some 12 countries had incurred external payments arrears, by 1982 the figure had risen to 32." Mexico and Brazil are only the most sizable and the best publicized examples of countries which at a time global recession cannot manage their debt services burdens.

LDCs don't have the export earnings to repay their borrowings or, it seemed in the second half of 1982, the commercial bank financing to roll them over. A recent Morgan Guaranty publication noted that "After more than a decade of very rapid expansion international lending, especially to developing countries, is slowing sharply." As a consequence of this slowing process, some observers see a gap of from $45 to $50 billion in borrowing needs next year. (Reduced OPEC surpluses could contribute significantly to a liquidity squeeze).

The abrupt retrenchment in terms of reduced imports and public spending which this will require of LDC governments could have serious political implications. Moreover, it will have implications for those industrial countries which hope to fuel their recoveries through exports to those same LDCs.

Exchange rate fluctuations.—The rapid and sizable swings in the value of currencies, swings which often did not accurately reflect changes in underlying economic fundamentals, have contributed to the destabilizing of the global economy. One observer has noted "the mix of huge (United States) budget deficits and very high interest rates which have sucked intenationally mobile capital into the dollar and propelled it far beyond the level which can be justified on any reading of underlying relations between the United States and other countries."

Between June 1980 and November 1982, for example, the U.S. dollar appreciated 27 percent against the Japanese yen. This was only one example of a significant strengthening of the dollar against major world currencies which took place during this period. One observer holds that the dollar is up to 20 percent over-valued at present with very negative consequences for U.S. exports.

These swings in exchange rates have made business planning more difficult and costly. One observer has noted that "the effect of arduously negotiated tariff concessions are likely to be swamped by large exchange rates changes."

Trade restrictions.—As noted above, for the first time since World War II international trade is declining. The global recession and exchange rate imbalances are contributing factors but increased barriers to free trade is contributing as well to this decline. For example, in the last 2 years the United States has obtained or imposed: "Voluntary" restraints on Japanese car exports to the United States; tightening of the multi-fibre agreement; import quotas on sugar; and "voluntary" restraint agreement on steel.

At a time of great economic hardship generally the pressures for increasing these barriers to free trade (in response to what is viewed as unfair trading practices by others) are increasing.

Others have pointed to what they see as an increasing tendency to use economic embargoes to achieve political ends. The Carter Administration grain embargo and Reagan Administration pipeline sanctions are two often cited examples of economically disruptive embargoes.

UNITED STATES SENATE,
COMMITTEE ON FOREIGN RELATIONS,
Washington, D.C., December 27, 1982.

Memorandum to: Members of the Committee on Foreign Relations.
Thru: Ed Sanders and Jerry Christianson.
From: Joel Johnson, Cas Yost, Janice O'Connell, and Gerald E. Connolly.
Re: Hearings on the International Financial System: "LDC Needs and Prospects."

The Subcommittee on International Economic Policy will hold the second in a series of seven hearings in Room 4221 Dirksen Senate Office Building at 2:00 p.m., Monday, January 10, 1983, on LDC Needs and Prospects. Senator Mathias will preside. Witnesses include: Mr. Larry Krause, Senior Fellow, Brookings Institution; Mr. John Sewell, President, Overseas Development Council; and Mr. John Mellor, Executive Director, International Food Policy Research Institute.

SUMMARY

During the past two decades, less developed countries (LDCs) have experienced more impressive economic growth rates than the industrialized countries. Even the economic shocks of the mid-seventies hurt their economies less than those of the industrial states. Today, however, external factors threaten that record, as the volume of world trade has declined for the first time and commercial lending institutions have cut back on their lending to the Third World. These reductions in trade, aid and credits make it increasingly difficult for LDCs to obtain the financial resources and necessary imports to maintain previous levels of economic growth.

BACKGROUND ON GROWTH

Over the past two decades economic growth rates in the LDCs have rather consistently been a percentage point or two above that of the industrial countries. Obviously, growth has varied widely among countries. Some Latin American and East and Southeast Asian countries registered impressive rates of growth, while most sub-Saharan African countries experienced little or no real economic growth. Furthermore, the higher population growth rates in the developing world meant that per capita economic growth was actually slightly below that of the industrial countries, but again with marked differences among countries. Overall, during the post World War II period, a time when many LDCs had just gained their independence, overall economic growth among the LDCs compared favorably with then current growth rates in the industrialized countries, and with economic growth rates experienced by presently industrialized countries during earlier periods in their history.

In spite of the past economic performance of the LDCs, development experts have in the past two or three years issued increasingly gloomy predictions concerning prospects for economic growth in the Third World over the remainder of this decade. This pessimism is primarily related to international factors. There is general agreement among such experts that LDC domestic policies are critical to economic success or failure, and there is widespread belief that many developing countries had improved their domestic performance in recent years. Many "middle income" LDSs were opening up their borders to greater competition through trade, and becoming more receptive to international investment flows. Many of the poorer LDCs had begun to pay more attention to their agricultural sector and to attenuate policies which created major distortions in the domestic prices of food, energy and export commodities. However, it is unclear whether any changes in policy can restore LDC growth patterns to that of the previous two and a half decades if industrial countries cannot resolve their own domestic economic difficulties.

TRADE, AID, AND COMMERCIAL FINANCIAL FLOWS

Developing countries rely on the industrialized nations for needed inputs for their economy, such as machinery, intermediate goods, and technical knowhow, and for financial resources to supplement their own investment resources. In order to obtain these inputs from abroad, countries need foreign exchange, which they obtain through trade, borrowing, or aid programs. In order to augment domestic investment, countries may also seek equity or debt financing, as well as concessional assistance.

Trade

In the post war period, in a rapidly expanding world economy, developing countries made increased use of all these mechanisms. For example, in the period 1960–1980 world exports in nominal dollars increased by a factor of 16. The LDC share of those exports jumped from 21 percent of the total to 27 percent. Even excluding exports of OPEC countries the LDC share of remaining exports increased from 14 percent to 16 percent. By any measure developing countries demonstrated a strong export performance in the context of rapidly expanding world trade.

LDCs have also adapted to changing market conditions by increasing their export of manufactured goods. In 1960 such products accounted for only 14 percent of developing country exports; by 1980 they accounted for around 22 percent. If fuels are excluded, in 1960 debt is needed simply to roll over old loans and to pay interest on debt outstanding. With decreased OPEC surpluses, there is less capital available to be loaned, while real interest rates are at historically high levels (around 7 percent, as compared to 2 percent in the sixties and negative rates in the mid-seventies).

Investment is also likely to drop in coming years. With prices and demand for raw materials at post World War II lows, there is little incentive to make long term investments in new export-oriented facilities. While there is potentially a large domestic market in LDCs for various consumer products and intermediate goods, the prospect that these countries will have difficulties in obtaining foreign exchange raises questions as to their ability to pay for needed machinery, parts, and inputs, or to make foreign exchange available for repatriation of profits.

Development assistance

The rapid acceleration in private financial flows to the LDCs over the past two decades was accompanied by increases in concessional assistance, particularly to the poorest countries. Over this period concessional assistance increased sevenfold in nominal terms, from roughly $5 billion in 1960 to $34 billion in 1980. Even in real terms official development assistance (ODA) more than doubled over the past two decades.

However, several underlying trends should be noted. Over the period United States aid declined in real terms, as a percentage of GNP and as a share of the Federal budget. This decline was more than offset by increases in ODA from most other industrial countries, and in the late seventies from OPEC countries which began their own programs. Consequently, U.S. assistance, which was about half of worldwide assistance in the 1960's, is now approximately one-fifth of total aid, and continues to fall. Among the industrial country donors, ODA was increasingly provided through contributions to multilateral institutions. Currently over a third of industrial country aid is provided through multilateral channels, as compared to 16 percent in 1970. Finally, ODA has gradually shifted away from middle income countries in Latin America and East Asia towards sub-Saharan Africa and the Asian subcontinent.

Future prospects for ODA are uncertain. Most industrial countries, other than the United States, have pledged to increase their foreign assistance in absolute terms and as a percentage of their GNP. But stagnant economies will make meeting this pledge difficult. The depreciation of most currencies against the dollar has also meant that even though a number of industrial countries have increased their aid in terms of local currencies, the purchasing power of this assistance has risen much less rapidly. For these reasons donors have recently shown increased reluctance to allow budget growth in international organizations. The Reagan Administration has in fact expressed an interest in providing a greater portion of its aid on a bilateral basis. If other countries follow suit, this shift will likely mean that less aid will be available to many of the poorest, although less politically important, countries.

PROSPECTS FOR DEVELOPING COUNTRIES

Soft or declining markets for most LDC exports, caution on the part of bankers and corporate investors, and constant or declining real levels of development assistance, are likely to mean growth rates in the LDCs below those experienced over the past three decades. Nevertheless, the middle income countries are still likely to continue to register growth rates above those in the industrial countries and poorer developing countries, particularly if protectionist measures do not greatly increase. These countries have shown an ability to shift into new product lines in response to changes in industrial country demand or to increased competition from lower income countries. The key question for these countries is likely to be the way in which the financial community addresses the current debt problems of several of these countries (Mexico, Argentina, Brazil), and the degree to which concern about these countries is generalized to others which have not experienced a debt servicing problem.

Oil exporting countries are not likely to see a return to the revenue levels which were possible in the seventies. OPEC countries have shifted from a trade surplus of $104 billion in 1980 to a projected deficit of $15 billion in 1982. However, their resources will certainly exceed those of the fifties and sixties, and if they pursue sound domestic economic policies and avoid international entanglements, they should be able to maintain economic growth rates well above those of most of the LDCs.

The poorest countries face the bleakest future. Per capita income in most of sub-Saharan Africa is likely to stagnate or decline over the rest of the decade, as demand for their primary products remains weak and increased ODA is not available to fill the gap. Changes in domestic policies could encourage greater agricultural output, particularly in cereals, but if foreign exchange is unavailable for fertilizer and pesticides, even sound domestic policies may not help much.

IMPLICATIONS FOR THE INDUSTRIAL COUNTRIES

The pessimistic outlook for economic development in most LDCs is a matter of concern for industrial countries. From a strictly humanitarian point of view, we can expect increased refugee problems and illegal migration, both within the Third World and between the Third World and industrial countries. Slow economic growth, particularly in the poorer countries, combined with a rapidly increasing labor force, obviously means that part of that force will seek employment in other countries.

From an economic perspective, slower growth in the LDCs will mean that their demand for products from the industrial countries will decline. For example, IMF programs for Argentina, Brazil and Mexico require those countries to reduce their collective Balance of Payments deficit in 1983 as compared to 1982 by $10 billion. In 1981 the United States, which was the major industrial country supplier to those countries, exported $24 billion to them. Clearly that level of exports cannot be sustained under new austerity programs. Certain high technology industries such as aircraft, machine tools and construction equipment, which are already seriously affected by stagnation in industrial country economies, will suffer further from this drop in demand from the LDCs.

Finally, the Western industrial countries have a long term interest in social and political stability in the LDCs. A rapidly expanding world economy with increased flows of trade, aid, and private capital between the industrial West and the developing countries, was a major factor in promoting Western-oriented governments and models of development. A slowing world economy may conversely mean greater political pressures on governments as population growth outstrips economic growth, and a shift to more autarkic and nationalistic economic policies, particularly if international markets and resources flows become less available to LDC economies. Such shifts are unlikely to serve the political and security interests of the United States and its Western allies.

APPENDIX

[Average annual percentage change]

Country group	1960–73	1973–80	1980	1981	1982
All developing countries	5.8	4.6	4.0	2.2	3.9
Low-income	4.1	4.5	5.9	3.9	3.9
China	4.7	5.3	6.8	3.0	....
India	3.5	3.8	6.5	5.6	....
Other	3.8	3.1	2.9	4.3	....
Africa	3.8	1.3	.4	2.7	....
Asia	3.8	5.2	5.5	5.9	....
Middle-income	6.4	4.7	3.5	1.7	3.8
Oil exporters	6.4	4.4	3.0	3.3	4.6
Oil importers	6.3	4.8	3.7	1.0	3.5
East Asia and Pacific	8.2	7.5	3.5	7.2	....
Latin America and Caribbean	5.9	5.4	5.6	−2.5	....
Sub-Saharan Africa	4.4	3.3	4.2	1.7	....
Middle East and North Africa	5.0	3.6	4.7	−0.5	....
Southern Europe	7.0	3.4	1.4	2.0	....
High-income oil exporters	8.6	8.3	4.5	−11.3	−1.0
Industrial market economies	5.1	2.5	1.4	1.2	.2
Industrial nonmarket economies			2.7	1.8	3.0

[Percent]

Country group	1955	1965	1970	1980 [1]
All developing countries	27.3	20.2	18.4	21.4
Low-income	5.6	3.4	2.5	1.9
China	1.4	1.0	0.7	0.9
India	1.4	0.9	0.6	0.4
Other	2.8	1.5	1.1	0.6
Middle-income	21.7	16.8	19.5	19.5
Major exporters of manufactures	6.8	5.7	6.2	8.0
Other oil importers	6.9	4.1	4.3	3.9
Oil exporters	8.0	7.0	5.4	7.6
High-income oil exporters	2.1	2.5	2.4	10.2
Industrial nonmarket economies	8.5	10.9	10.1	7.9
Industrial market economies	62.1	66.5	69.0	60.5
Europe	36.1	41.1	42.5	38.5
Japan	2.1	4.5	6.2	6.5
United States	16.5	14.6	13.6	10.9
World	100.0	100.0	100.0	100.0

Country group	1955	1965	1970	1980 [1]
Memorandum item:				
World exports (billions of dollars):				
Current prices	$94	$186	$313	$1,995
1978 prices	420	542	821	1,405

[1] Includes some estimates.

III. NET FINANCING FLOWS, ALL DEVELOPING COUNTRIES, 1970–90

[Billions of current dollars]

Net financing	1970	1980	1981	1982	Projected, 1990		Annual growth rates		
					Low case	High case	1970–80	1980–90 low case	1980–90 high case
Official transfers	1.2	12.1	12.8	13.6	28.3	32.7	26.0	8.9	10.5
Private direct investment	2.5	11.8	15.3	15.8	19.4	24.4	16.8	5.1	7.5
Medium- and long-term loans, net disbursements	9.1	57.3	71.4	81.0	99.2	151.1	20.2	5.6	10.2
Official	4.1	20.4	23.4	25.0	44.0	54.9	17.4	8.0	10.4
Private	5.0	36.9	48.0	56.0	55.2	96.7	22.1	4.1	10.1
Total [1]	12.8	81.2	99.5	110.4	146.9	208.2	20.3	6.1	9.9
Total (1980 prices)	32.7	81.2	99.5	102.5	82.1	116.3	9.5	0.1	3.7
Memorandum items:									
Net exports (goods and services)	−8.5	−59.1	−88.7	−75.8	−61.3	−110.0	−21.4	−0.4	−6.4
Current account balance [2]	−10.9	−75.0	−117.3	−109.2	−124.5	−182.7	−21.3	−5.2	−9.3
Net official development assistance [3]	4.1	22.8	23.6	25.8	53.6	65.7	18.7	8.9	11.2
Debt outstanding and disbursed	63.7	445.2	516.6	597.6	1,287.0	1,450.0	21.5	11.2	12.5

[1] Excludes short-term capital and reserve changes.
[2] Excludes official transfers.
[3] Net ODA is defined as net disbursements of concessional official loans plus official transfers.

Note: Developing countries exclude China.

Source: World Development Report, 1982.

United States Senate,
Committee on Foreign Relations,
Washington, D.C., January 12, 1983.

Memorandum to: Members of the Committee on Foreign Relations.
Thru: Ed Sanders and Jerry Christianson.
From: Joel Johnson, Cas Yost, and Janice O'Connell.
Re: Hearing on the "International Financial System: Global Debt."

The Subcommittee on International Economic Policy will hold a hearing on Wednesday, January 19, 1983, at 10:00 a.m. in Room SD-419 (4221 DSOB) on the magnitude and implications of current and projected developing countries' debt situation. Senator Mathias will preside. Witnesses will include two panels:

Panel I.—The Honorable John G. Heimann, Co-Chairman, Warburg, Paribas, Becker, Inc.; Mr. Rimmer De Vries, Senior Vice President and Chief International Economist, Morgan Guaranty Trust; and Mr. Robert Solomon, Guest Scholar, Brookings Institution.

Panel II.—Mr. Felix G. Rohatyn, Senior Partner, Lazard Freres and Company; and Mr. William Cline, Senior Fellow, Institute for International Economics.

SUMMARY

Following the first oil shock in 1973-74, developing countries (LDCs) began to rapidly increase their international borrowing. Some smaller countries encountered problems servicing the debt throughout the decade, but in recent months, real or potential difficulties of several major LDCs, including Mexico, Argentina, Brazil, and Venezuela, have raised concern about the overall exposure of the private banking system and the ability of official multilateral mechanisms to deal with a financial crisis in one or more of these countries. These countries have been hard hit by high real interest rates and decreased export earnings, making debt service much more difficult. The hearings will review the degree to which these countries must make internal adjustments, to what extent a revived international economy with lower interest rates would automatically reduce the problem, and whether the international economic institutions and commercial banks are equipped to deal with the current situation and future scenarios.

MAGNITUDE OF PROBLEMS

Third World external debt has grown from approximately $100 billion in 1973 to $540 billion in 1981 and is estimated to have reached $630 billion by the end of 1982. Brazil, for example, owes $80 billion, Mexico $80 billion, Argentina $37 billion, and South Korea $35 billion. The problem is not simply the amount of principal owed by these countries. Over the past two to three years, as real interest rates have increased, the cost of servicing this mounting debt has skyrocketed. At the same time, slow growth in industrial countries has meant weak demand and soft prices for Third World exports. This latter problem has recently even affected oil exporting LDCs. As a result, Argentina's debt service (payments of principal plus interest) now equals 78 percent of its export earnings while Brazil's debt service is about 67 percent of export earnings. Many bankers regard 20 percent as a prudent maximum. Tables I, II and III (attached) provide some idea of the nature of Third World debt and the principal debtor countries.

Many developing countries began to amass large debts following the sharp increase in oil prices in order to maintain current consumption and growth without making adjustments to these high energy costs. Large OPEC surpluses which accumulated as deposits in commercial banks led to pressure on these banks to lend, so that many countries found a receptive market for their borrowing demands. Furthermore, high levels of inflation meant, when nominal interest rates lagged, that real interest rates were often actually negative, and high inflation levels also meant that countries would be paying back principal with cheaper dollars.

As OPEC surpluses declined in the eighties and industrial countries began applying tight monetary policies, real rates of interest climbed, export earnings dropped, and bank loans became more difficult to obtain. A number of smaller countries were already in trouble. According to The Economist, "a record 26 countries are now reported to be late on external debt repayments of one sort or another." As long as these were relatively small countries, the international system could easily cope with commercial banks and creditor governments rescheduling past due debts and the IMF providing financial assistance and technical advice. Now, however, several of the developing countries which have amassed very large quantities of debt and account for as much as one-third of debt held by the Third World, are in serious difficulties.

PROBLEM COUNTRIES

Mexico

The current situation in Mexico has precipitated the recent concern with major Third World debts. Its international debt is approximately $80 billion, of which about $25 billion is owed to U.S. commercial banks and another $2 billion to the U.S. Government. Last February, the peso was devalued by 40 percent. Inflation and balance of payments deficits continued unabated in Mexico, and on August 6th, the Central Bank of Mexico withdrew from foreign exchange markets. The peso again plummeted, from around 40 to the dollar to 70–100 to the dollar. Capital flight continued, and on September 1, during the State of the Union address, the President of Mexico announced his decision to nationalize Mexico's banks and impose exchange controls.

With the United States in the lead, governments put together an emergency rescue package. The United States prepaid Mexico $1 billion for oil for the Strategic Petroleum Reserve, and advanced Mexico another $1 billion in CCC credits. Twelve central banks, through the Bank of International Settlements, participated in a $1.85 billion swap of hard currencies for pesos. Commercial banks agreed to roll-over Mexican debt falling due during the ninety day period August 23–November 21. Meanwhile, Mexico continued negotiations with the IMF for a three year Extended Fund Facility Agreement.

An agreement was finally concluded with the IMF on December 23. The agreement involved lending $3.9 billion to Mexico over a three year period. The funds will be disbursed in installments as long as Mexico adheres to the policy requirements in the agreement. Mexican authorities have already taken several such steps, including doubling gasoline prices, increasing wheat flour and sugar prices, allowing interest rates on savings to increase to 57 percent (inflation was 98 percent last year), and establishing a new dual exchange rate which includes a free market price for the peso (now at about 150 pesos to the dollar, as compared to the controlled rate of 95 to the dollar). Commercial banks have responded by agreeing to a massive rescheduling of Mexican debt. Debts amounting to $20 billion which were due in the period August 31, 1982 to December 31, 1984 have been rescheduled, and banks will also make available $5 billion in new loans in fiscal year 1983.

Brazil

Brazil is the second largest holder of international debt—about $80 billion overall, of which $20 billion is owed to the United States. Brazil, which was accustomed to growth rates of 6–7 percent, increased its borrowings in the seventies to cover increased cost of oil. In recent years, the country has launched austerity programs in an effort to reduce its trade and budget deficits. In 1982 Brazil produced a modest trade surplus. However, high real interest rates meant it still suffered a current account deficit of around $12 billion. The shock to the banking community of the difficulties encountered in Mexico and Argentina also indirectly affected Brazil, as in the last quarter of 1982 when availability of credit for Brazil contracted markedly. As a result, Brazil also faced an emergency liquidity crisis.

Brazil has now completed negotiations with the IMF for drawings of about $5.5 billion over the next three years. In exchange Brazil has agreed to reduce its budget deficits from 6.5 percent of GNP in 1982 to around 2.5 percent in 1984, cut government subsidies to state enterprises, and devalue its currency each month by 1 percent over its inflation rate—hence producing a real devaluation of 12 percent by the end of the year. It also agreed to limit its new foreign borrowing to $6 billion in 1983, as compared to $14 billion in 1982. Commercial banks have agreed to provide most of the $4.4 billion in new funds Brazil is seeking initially, and to reschedule principal owed in 1983.

Argentina

Another troublesome country is Argentina. It currently has external debt totalling $37 billion, of which $9 billion is owed the United States. Its economy was already in serious difficulties before the war broke out over the Falklands. War-related expenses, plus economic sanctions imposed by Britain and other members of Economic Community compounded Argentina's difficulties.

Argentina has also just completed negotiations with the IMF for a standby agreement which is expected to go before the Board this month. It would involve credits of $1.65 billion over a 14-month period, as well as a possible drawing from the IMF's Compensatory Finance Facility. Argentina in turn would agree to undertake a number of economic measures, including reducing its budget deficit from 14 percent of GNP in 1982 to 8 percent in 1983, cutting its inflation rate (wholesale prices) from 310 percent in 1982 to around 160 percent by the end of 1983, liberalizing the import regimen allowing an increase in real interest rates, delaying increases in public sector wages, and rationalizing prices of public enterprise goods (gas, electricity, etc.).

Venezuela

International debt experts are also carefully watching Venezuela, which like Mexico, is an oil producer that has borrowed heavily based upon assumptions of high long-term oil prices. Unlike Mexico, however, Venezuela began an austerity program in 1979, and has essentially limited borrowing to rolling over debt as it comes due. Currently Venezuela owes about $29 billion, but has a strong reserve position—$15 billion. Its major problem relates to the question of whether politically a democratic country such as Venezuela can continue with zero growth (since 1979), when its historical rates were on the order of seven percent annually during most of the seventies, without radical shifts or pressures on its political system.

COMMERCIAL BANK EXPOSURE

Since 1973 when the first round of oil prices increases drastically altered both the size and distribution of balance of payments deficits, the private commercial banking system has performed a steadily increasing role in lending to developing countries' governments. The 1973–74 oil price rise raised the specter of disaster as dollars flowed out to national treasuries and into OPEC coffers. The energy costs of the LDCs escalated dramatically. The commercial banks "recycled" the funds and were successfully able to provide needed resources to deficit countries with relatively minor disturbances in international money markets. The banks performed a similar role following the 1979 increases in oil prices. With each successive round of "recycling" by the commercial banks, increasing quantities of external debt were amassed by the developing countries, with debts being highly concentrated in a few higher income LDCs.

By the end of 1982, four-fifths of the $630 billion external LDC indebtedness was owed to private commercial banks. Slower growth worldwide, increasing rates and shorter maturities of loans have added to the financial burdens of developing countries at a time when their export earnings have fallen, largely as the result of weak export prices.

Deficit financing requirements in 1982 were only slightly less than the $100 billion required in 1981. Yet, recent events in domestic financial markets, coupled with serious difficulties in the economies of some of the banks' most important LDC clients, have raised questions as to whether banks can or will continue to provide financial assistance at past rates. (See Table III). Further, some critics have raised questions concerning whether their past lending practices may have called into question the stability of the international financial system.

International bank regulation and supervision

The growing interdependence of international banking activities has resulted in the activities of U.S. banks becoming intertwined with those of foreign banks and so vulnerable to the actions of those banks. A number of bank failures and near bank failures in the United States and Germany demonstrated this increased interpendence and sent shock waves through the international banking system in 1974. The closing of Bankhaus I.S. Herstatt—one of Germany's largest private banks—in June of 1974 was closely followed by the closing of Franklin National Bank of New York—the twentieth largest bank in the United States. Because of the extent of interbank lending that had gone on in each of these cases, other banks lost considerable sums in unpaid foreign exchange commitments that the closed banks were unable to honor.

Following these events the Board of Governors of the Bank for International Settlements (BIS) established the Committee on Banking Regulations and Supervisory Practices comprised of bank supervisors from the United States, United Kingdom, Germany, Canada, France, Belgium, Switzerland, Sweden, The Netherlands, Italy, Luxembourg, and Japan. This committee reached agreement on principles of cooperation to deal with banking and jurisdictional issues—the so called Concordate of 1974. The Concordate establishes guidelines to ensure that all banks are adequately supervised be they a domestic bank, a foreign branch or subsidiary. Also it establishes framework for action in cases of bank solvency which might threaten the safety and soundness of the domestic banking system.

Recent events in Mexico, Brazil and Argentina have high-lighted the sizable foreign exposure of a number of U.S. banks. The nine largest U.S. banks exposure in just those three countries is equal to 130 percent of their total capital. Yet their loss reserves for those loans (reserves set aside in case the loans do not get repaid) have, at least until recently, represented only 12 percent of their total exposure. A number of smaller regional banks also have sizable exposure internationally relative to their capital holdings.

In the United States, under Federal and State banking laws, a bank's lending to any one individual is limited to 15 percent of the bank's capital funds. This lending limit was enacted for prudential reasons. Federal authorities have interpreted this limit with respect to lending to foreign governments to mean that for purposes of calculating exposure, a bank must consider lending to the central government and to state entities which do not have a means of generating revenue independently to repay their loans as loans to one individual for lending limit purposes. However, loans to the private sector, or to a state owned oil company for example would not be consolidated with loans to the central government for lending limit purposes. The recent Mexican situation, where private debtors were unable to obtain the necessary foreign exchange in order to repay loans, may have revealed a weakness in the current interpretation of this so-called 15-percent rule.

OFFICIAL ASSISTANCE

The Annual Meetings of the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD) in Toronto last September focused on the state of the world economy and the adequacy of official resources to meet future needs. Most participants agreed that while world economic developments during 1981 and 1982 were marked by some signs of progress, by and large, the general economic situation remained troublesome, posing major challenges for both national governments and international institutions. It was in this context that the United States proposed that a "special fund" be created at the IMF in order to cope with unforeseen, but potentially sizable balance of payments problems of some of the largest deficit countries, both developed and developing. This fund would have been in addition to the eighth increase in IMF quotas which is scheduled to come into effect in 1985. Many LDCs were urging a quota increase of 100 percent, while the United States suggested that it was only prepared to think in terms of an increase below 25 percent.

U.S. proposals did not meet with much enthusiasm, and the Administration has subsequently suggested quota increases of 50, combined with an expansion in resources and the mandate of the General Agreement to Borrow (GAB). The GAB currently is an agreement among the largest 10 industrial countries (G–10) to make additional resources available to the IMF for use by one of the G–10. Under the Administration proposal, the GAB commitments would be increased and made available under certain circumstances to help out any IMF member. This approach is evidently being greeted with more interest by other countries, and the United States hopes to reach a new accord on IMF resources in February.

Concerns of commercial banks about lending to Third World countries also increased interest in Toronto in discussions on IDA VI, which lends to countries which normally do not obtain much lending from commercial banks anyway. Negotiations were held to devise a method for handling U.S. arrearages in its IDA VI commitments and to bridge the gap between IDA VI and IDA VII. All other donors finally agreed to make their final IDA VI contribution on time even though the United States would be unable to do so, and also to provide roughly one third of their IDA VI contributions to IDA in fiscal year 1984. Agreement was also reached to begin discussions on the IDA VII replenishment in November.

TABLE I.—THIRD WORLD DEBT

[In billions of dollars]

Source of lending	Annual debt service					Total nominal debt [1]				
	1971	1978	1979	1980 preliminary	1981 estimate	1971	1978	1979	1980 preliminary	1981 estimate
1. DAC countries and capital markets	9.3	49.8	64.6	79.9	98.3	68.8	261.8	308.7	351.0	398
ODA	1.4	2.3	2.6	2.9	3.3	24.7	49.0	53.1	57.0	61
Total export credits	5.2	21.0	25.5	31.0	38.0	27.5	85.3	100.7	114.0	128
Capital markets [2]	2.7	26.5	36.5	46.0	57.0	16.6	127.5	154.9	180.0	209
Of which: bank loans	NA	23.2	32.3	41.0	51.0	9.4	105.7	129.9	149.0	172
2. International organizations	.9	3.2	3.8	4.9	6.0	10.0	40.2	47.9	56.0	65
Of which: consessional	.3	.8	.8	.9	1.0	3.2	16.4	19.6	23.2	27
3. Centrally-planned economies	.6	1.4	1.7	2.1	2.5	6.4	13.8	16.2	18.2	21
4. OPEC countries		.9	1.4	1.8	2.0	.4	13.2	15.2	18.5	23
5. Other LDCs	.1	.7	.8	1.1	1.4	1.0	4.1	5.3	6.5	9
6. Unspecified and adjustments		.9	1.3	1.4	1.5		3.5	4.0	6.0	8
Total	10.9	56.9	73.6	91.2	111.7	86.6	336.6	397.3	456.2	524
of which:										
Interest	3.3	19.8	26.0	34.9	46.5					
Amortisation	7.6	37.1	47.6	56.3	65.2					
Annual nominal increase (percent)	16	38	30	24	22	16	27	18	15	15

---

[1] Disbursed at year end.

[2] Bank loans (other than export credits), bonds and other private lending.

TABLE II.—THE 20 DEVELOPING COUNTRIES WITH THE LARGEST DEBT-SERVICE PAYMENTS [1]

(In billions of dollars)

Country ranked by average debt service in 1979–80	Debt service paid				Disbursed debt year-end			Total reserves year-end		Percent GNP growth rate per annum, 1970–79	Per capita GNP, 1979
	1978	1979	1980 preliminary	1981 estimate	1978	1979	1980 preliminary	1978	1980		
1. Brazil	8.1	10.8	13.4	16.0	44.2	50.6	56.6	11.9	5.9	8.7	$1,687
2. Mexico [2]	7.0	11.0	9.0	12.2	30.5	34.5	42.4	1.9	2.9	5.1	1,592
3. Venezuela [3]	1.6	2.8	5.1	6.8	9.7	11.6	13.2	6.6	7.1	5.9	3,135
4. Algeria [4]	2.0	3.3	4.2	4.6	14.7	17.4	17.8	2.2	4.0	5.9	1,578
5. Spain	3.0	3.2	4.1	4.9	13.1	15.0	18.2	10.8	12.5	4.0	4,338
6. Saudi Arabia [3]	1.8	2.9	(3.5)	(4.0)	2.3	3.1	4.0	19.4	23.6	11.4	7,373
7. South Korea	2.0	2.9	3.3	4.0	12.5	15.6	20.5	2.8	2.9	9.9	1,501
8. Yugoslavia	1.8	2.5	2.9	3.5	11.3	13.3	15.0	2.5	1.5	6.5	2,430
9. Argentina	2.2	1.8	2.8	3.6	7.8	11.3	14.0	5.2	6.9	2.7	2,281
10. Indonesia [3]	1.6	2.3	2.3	2.7	14.5	15.6	17.0	2.6	5.5	6.9	376
11. Chile	1.5	1.6	1.9	2.5	5.3	7.1	8.8	1.2	3.2	3.2	1,781
12. Iran [3]	2.4	1.9	(1.4)	(6.5)	10.6	(9.9)	(9.5)	12.1	10.0	6.4	2,028
13. Peru [2]	.8	1.1	1.9	2.1	6.0	6.8	6.9	.4	2.0	2.6	726
14. Egypt [2]	1.4	1.2	1.7	2.0	10.3	12.0	12.7	.6	1.2	7.5	455
15. Philippines	1.3	1.3	1.5	2.0	6.2	7.2	9.5	1.8	2.9	6.3	601
16. Greece	.9	1.2	1.6	2.0	4.8	5.6	6.5	1.2	1.3	5.1	3,890
17. Taiwan	.9	.9	1.3	1.6	3.5	3.9	4.9	1.5	2.4	9.9	1,802
18. India	1.1	1.1	1.1	1.3	15.9	16.6	16.7	6.8	7.3	3.1	191
19. Morocco	.6	.9	1.2	1.6	5.4	6.6	7.5	.7	.4	6.1	740
20. Thailand	.8	1.0	1.1	1.4	2.6	3.7	5.6	2.1	1.7	7.4	592
Total	42.8	55.7	65.3	85.3	231.2	267.4	307.3	94.3	105.2		
Percent of total LDC's	76	76	72	76	69	67	67	62	51		

---

[1] Next ranking countries include Turkey (whose original debt service obligations of over $2 billion in 1980 were substantially reduced by debt relief), Israel (excluding military debt), Ecuador, Libya and Portugal.

[2] Net oil exporter.

[3] OPEC member.

TABLE III.—OUTSTANDING INTERNATIONAL CLAIMS OF COMMERCIAL BANKS REPORTING TO THE BANK FOR INTERNATIONAL SETTLEMENTS ON NON-OPEC DEVELOPING COUNTRIES

[In billions of U.S. dollars]

	December 1976—			December 1981—		
	Total	U.S. banks	U.S. share (percent)	Total	U.S. banks	U.S. share (percent)
Non-OPEC developing countries	80.9	41.9	52	230.0	90.0	39
Mexico	17.9	11.7	66	55.4	21.6	39
Brazil	21.2	10.9	52	49.6	18.4	37
Argentina	3.4	1.9	57	22.9	9.5	41
South Korea	3.9	3.0	77	16.5	8.7	53
Chile	1.1	.8	72	9.6	5.4	56
Philippines	2.6	2.0	76	7.2	4.4	61
Taiwan	2.6	2.0	77	5.6	4.5	80
Others	28.2	9.6	34	63.2	17.5	28

UNITED STATES SENATE,
COMMITTEE ON FOREIGN RELATIONS,
Washington, D.C., January 28, 1983.

Memorandum to: All members of the Foreign Relations Committee.
Thru: Ed Sanders and Jerry Christianson.
From: Cas Yost and Janice O'Connell.
Subject: Continuation of Hearings on the International Financial System: Recommendations for the Future.

The International Economic Policy Subcommittee will hold the fourth in its series of hearings on the International Financial System on February 1, 1983, at 10:00 a.m. in room SD-419 (4221 DSOB). Senator Mathias will preside. The witnesses will include the following: Senator Bill Bradley (D.-N.J.); the Honorable G. William Miller, G. William Miller and Company; the Honorable Robert Hormats, Goldman Sachs; and William Ogden, Vice Chairman, Chase Manhattan Bank.

During this hearing the Subcommitee will receive testimony commenting on a variety of proposals which have been offered in order to cope with the current pressures placed on the international monetary system by the current economic recession.

BACKGROUND

During the first three hearings of the Subcommittee, testimony from experts centered upon their assessments of the current state of the international economy and prospects for future economic recovery. Their testimony also included assessments of what continued slow or no economic growth in the near term implies for the manageability of the international debt situation, the future stability of the international financial system, and for economic growth and political stability in the Third World. In the course of those hearings, a number of important observations were made and proposals offered for addressing the current international economic situation.

Slow growth is serious problem

First, it was clear to all that the current problems of the international financial system were symptoms of the decline in economic growth particularly in the economies of the developed world, with spillover effects on the economies of the developing world. It was noted that OECD countries are in the midst of the deepest and longest recession in the Post War period. Unemployment which has resulted from the recession has reached 32 million in the OECD countries—including 12 million unemployed in the United States—with an additional 2 million workers likely to be added to the unemployment figures by the end of 1983. Capacity utilization in the manufacturing sectors of the industrialized world has reached its lowest levels since the Great Depression—in the United States, only 68 percent of existing manufacturing capacity is currently being utilized.

Developing countries focus of concern

The developing world came in for careful analysis and comment both because of the importance of LDC's to the economies of developed countries, including the U.S. economy (more than one-third of our exports go to the LDC's), and because a great deal of the current concern over the state of the world economy is focused upon the mounting and seemingly unmanageable size of the debts which LDC's have incurred in large measure from loans by international banks incorporated in the industrial world (approximately 60 percent of $600 billion in outstanding LDC debt is owed to private commercial creditors). A sense of the growing unmanageability of LDC debts stemmed not only from the recent financial difficulties incurred by Brazil, Mexico, and Argentina, but also because, in the aggregate, in 1982 LDC's paid more in principal and interest than they earned from their exports of goods and services—clearly an unsustainable situation.

Change in economic policies recommended

A number of witnesses agreed with former Secretary of the Treasury Michael Blumenthal's assessment that industrial democracies had historically exhibited "an excessive desire for real income increases even when the productivity of the economies involved did not warrant it." The inter-related "shocks" of oil price hikes and escalating inflation contributed to throwing the global economy into a deep recession in 1981.

Much of the pessimism expressed in the hearings stemmed from the witnesses' assessment that ill-conceived restrictive domestic economic policies being pursued in the developed countries, and particularly the overly restrictive U.S. monetary policy, were unlikely to reduce historically high real rates of interest sufficiently to remove them as a serious barrier to sustained economic growth. Witnesses by and large agreed that without a reversal in the economic policies of most major industrial countries in the near term, any economic recovery which might take place would be weak and shortlived. The implications of such a pessimistic forecast upon the economic and social factors for the developing world was explored at length including the expressed concern that in this current economic environment, there were limits beyond which LDC's could not be expected to make internal economic adjustment to balance their external accounts without precipitating severe political and social reactions which would clearly not be in their self interest, not to mention U.S. foreign policy and national security interest.

A number of witnesses pointed to the pernicious effects of rapidly fluctuating exchange rates and, in the last year, of an over-valued U.S. dollar. The connection was made between the position of the dollar and the decline in U.S. export competitiveness.

MAJOR CHANGES IN POLICIES RECOMMENDED

Witnesses expressed the belief that until economic recovery occurs, there are continuing dangers to the system, including an outbreak of trade warfare, competitive devaluations, or even a possible financial collapse. Witnesses took note of the recent success that policy makers have had in containing inflation, but stressed that policies must be adopted which would stimulate economic growth. They stressed the need for closer coordination by economic policy makers in the industrialized countries in recognition of the interdependence of these economies and their importance to the performance of the international economy as a whole.

Some witnesses highlighted the need for the United States to reconsider the current monetary/fiscal policy mix being pursued (of overly restrictive monetary policy measures coupled with expansionary fiscal measures reflected in the sizable Federal budget deficits currently and projected.) They all cautioned that while the deficit would have to be reduced if confidence is to be restored to the economy, expenditure cuts and revenue raising measures which are required if future deficits are to be reduced, must be cautiously applied lest any economic recovery that might begin be retarded.

Experts stressed the vital role that appropriate U.S. economic policies must play if the root cause of the current financial crisis is to be eliminated. In particular they suggested that a change in U.S. monetary policy to one which is less restrictive would not only permit a decline in real rates of interest domestically, but would also permit U.S. allies to pursue more expansionary policies relieved from the burden of having to keep their domestic interest rates high to defend their exchange rates vis-a-vis the dollar.

MEASURES PROPOSED TO MANAGE THE CURRENT CRISIS

In addition to addressing themselves to the underlying cause of the current instability in the international financial system, witnesses also made suggestions and comments about a number of specific proposals to manage the current situation until economic recovery occurs. The following are some of the most discussed or controversial of the proposals offered.

Increase in IMF resources

The first proposal which will soon be before the Committee for consideration has been crafted by the finance ministers of various nations under the auspices of the IMF. The proposal calls for an the expansion in resources made available to the IMF by 50 percent to provide short-term balance of payment assistance to countries which find themselves unable to meet their external commitments. In the case of the United States this will take the form of legislation to increase the size of the U.S. quota by approximately $7 billion. Total IMF quotas will increase from $65 billion to $95 billion.

In addition, under the leadership of the United States, 11 industrialized countries (United States, United Kingdom, Germany, Japan, Italy, France, Canada, Netherlands, Sweden, Switzerland, and Belgium) have agreed to expand the resources they will make available to the IMF through the General Arrangements to Borrow (GAB) from $7 billion to $19 billion. Under the existing GAB agreement, the 10 participating countries have made loans of their currencies, up to agreed levels, to each other in times of emergency. The new proposal would open access to borrow from the GAB to all IMF members under certain conditions and with the approval of the 11 countries which will provide the funds. The United States will provide 25 percent of the total GAB (approximately $4.7 billion). U.S. participation in the GAB will require Congressional authorization—the specific amount of the Administration's budget request is still unclear because some resources still remain available in the current arrangement and it is unclear whether reauthorization of these funds will be required as well.

Both the GAB and IMF quota increase proposals have come under criticism as being measures aimed at bailing out banks for their imprudent lending. Witnesses however refuted this charge noting that even if this were the desired aim, the IMF has insufficient funds to repay private lenders for all outstanding loans. Furthermore, they note that the banks have not been receiving repayments of principal on many outstanding loans to developing countries, and have been forced to reschedule a sizable number of these loans, as well as provide additional funds to these countries to keep their economies functioning.

Private banks proposal

There has been discussion as well as to whether the institutional arrangements for dealing with financial crises such as occurred in Mexico in August and Brazil in December are sufficient. Some have stressed the need to insure the continued flow of financial resources (private and public) to debtor countries during this period of difficulty. There is general agreement on the need for better coordination between private and public lenders.

The major international commercial banks under the leadership of William Ogden of Chase Manhattan Bank have recently established an independent nonprofit organization, the Institute for International Finance, whose purpose will be to collect information on LDC debt exposure and to make it available to all bankers in order to prevent excessive lending by commercial banks to any one LDC borrower.

It is unclear what information, if any, this institute will be able to provide which isn't currently available through the publications of the Federal Reserve or the Office of the Comptroller of the Currency. In some measure the institute may have been established in order to demonstrate to the public and bank regulators that the banks themselves were prepared to take measures to ensure the safety and soundness of the banking system. This institute may also have been viewed as a preemptive strike to prevent the Congress or bank regulators from imposing additional regulations in the face of the current crisis.

Co-financing with IMF

In order to encourage the commercial bankers to continue to provide some 55–60 percent of the $100 billion of the resources which the LDC's are likely to require in 1983, if they are to meet their internal and external financial requirements, several economists have proposed that an umbrella of protection should be afforded to them via explicit linkage between such loans and IMF resources.

IMF officials have played a greater role recently as intermediaries between the debtor countries and the commercial banks in an attempt to handle the current financial crunch in an orderly manner. However, the Fund officials are reluctant to make this role more formal or explicit for fear of making their duties as an international institution more problematic. The banks for their part would welcome more information from the IMF but would be reluctant to submit their loans (terms and conditions) to IMF scrutiny or approval.

Establishment of an International Deposit Insurance Corporation

Another proposal to encourage commercial bank lending to continue, which all experts agree is necessary if the current crisis is to be managed, is the establishment of an International Deposit Insurance Corporation which would seek to protect banks and depositers not currently covered by national insurance programs. Such a proposal would require substantial resource contributions by governments which would come under criticism from some as a use of taxpayers' funds in order to bail out banks for imprudent lending. It would also require cooperation from so-called bank-haven countries which have virtually no regulations on banks incorporated within their borders.

Discounting of existing debt

One of the more radical proposals put foreward by Felix Rohatyn and others would establish a new institution to purchase the outstanding LDC debt from the commercial banks. Banks would receive in return long-term bonds issued by the institution. These bonds would be redeemed only after an extended period but would pay annual rates of interest to banks, albeit at rates set at lower levels then the banks are currently receiving on their rescheduled debts. The institution would then restructure the debt payments it would receive from the LDC's to a repayment schedule more manageable for the LDC's.

Exchange rate management

A number of witnesses maintained that the extreme fluctuations of exchange rates need to be better managed. No one expressed a desire to return to a fixed exchange rate regime but the desirability of more active Fed intervention in currency markets was supported by several witnesses.

United States Senate,
Committee on Foreign Relations,
Washington, D.C., February 8, 1983.

Memorandum to: Members, Committee of Foreign Relations.
Thru: Ed Sanders and Jerry Christianson.
From: Cas Yost, Janice O'Connell, Gerald E. Connolly and Hans Binnendijk.
Re: Secretary of State George Shultz's Testimony on "Stresses and Strains in the International Financial System".

The Foreign Relations Committee will hold a hearing on Tuesday, February 15, at 10:00 a.m. in Room SD-419 to hear testimony from Secretary of State George Shultz on "Stresses and Strains in the International Financial System." Senator Percy will preside.

BACKGROUND

The International Economic Policy Subcommittee has held four hearings on this same general topic in the last month. It received testimony from fifteen witnesses, including three former Secretaries of the Treasury, a former Chairman of the Council of Economic Advisors, and a former Comptroller of the Currency. Secretary of State Shultz has been asked to address himself to the foreign policy implications of strains in the global economic system. These hearings, together with one scheduled with Secretary of the Treasury, Donald Regan, on February 23, are intended to help provide the basis for Committee consideration of an anticipated Administration request to add a 50 percent quota increase for the International Monetary Fund.

SUMMARY OF INTERNATIONAL ECONOMIC POLICY SUBCOMMITTEE HEARINGS

Current global economic situation

In the course of its hearings on the Global Economy, the Subcommittee found a broad consensus among its witnesses, that the current world recession is the deepest economic decline since the Great Depression of the 1930's. Unemployment, and idle plant capacities in the West are at thirty year lows. At the same time the Less Developed Countries have experienced the lowest commodity prices and the highest debt burden they have had in the post World War II era. Continued contraction in the world economy may lead to what Felix Rohatyn warned would be a "unilateral repudiation of external debt by a country that is politically radicalized by depression, by IMF imposed austerity or a combination of both.

The origins of the current economic problems

The dramatic oil price increases of 1973-74 set the stage for an international economic drama. The oil price increase was, as Senator Bill Bradley described it, "like a gigantic tax increase on industrial economies and developing economies throughout the world." The industrial economies were able, after a period of adjustment in mid-decade, to meet this new "tax" by absorbing petrodollar investments, expanding their export markets to OPEC members, and conserving their energy consumption. The deep recession which ensued with the 1979 oil price increase was as much a result of tight monetary policies, especially in the United States, as it was a byproduct of the inflationary cycle generated by the price increase itself. In its wake, this recession has left 32 million workers in the OECD nations unemployed.

The effects in the developing nations have been considerably more severe. In order to maintain their high economic growth rates of the previous decade, the LDCs needed access to huge amounts of capital either through increased aid flows from the West, or through commercial bank lending. Since the real level of concessional aid flows increased marginally, if at all, most of the larger LDC economies turned to the private commercial sector for their capital needs. Between 1973 and 1982 LDC private debt grew from $40 billion to $375 billion. Prior to the 1979 recession these loans were a profitable business for the commercial banks. With tight monetary policies in place in 1979, and with concomitant high interest rates combined with lower inflation, things began to go sour. Large debtors sought to refinance and, as world trade declined in both 1981 and 1982, the LDCs witnessed a contraction in the industrialized markets that had heretofore been expanding. New loans were needed to refinance old debts. Debt service, expressed as a percentage of exports, has now risen to staggeringly high levels for some debtor-nations (e.g. 129 percent for Mexico, 122 percent for Brazil and 179 percent for Argentina).

As former Assistant Secretary of State for Economic Affairs, Robert Hormats, suggested, the world economy is now witnessing the convergence of three major negative forces envisioned as a "triangle of economic instability." The triangle is composed of prolonged recession and high unemployment on one side, debt related constraints on growth on another, and serious declines and protectionist pressures on the trading system on the third side. Each of these negative forces "in part results from, and contributes to, the others," Mr. Hormats stated.

Recommendations

(1) Witnesses were unanimous in asserting that a global economic recovery will be predicated on the size and the rate of recovery in the United States economy. Former Comptroller of the Currency John Heimann put it bluntly: "We cannot possibly solve the debt problem without real economic growth in the world and we cannot have real economic growth in the world without real economic growth in the United States." Several witnesses linked this real growth to reducing or eliminating the huge Federal budget deficits that have been projected through the late 1980's. "Strong measures to reduce what now appears to be a large structural debt in the Federal budget," Vice-Chairman of Chase Manhattan Bank William Ogden testified, "together with a stable monetary policy, are critical to our own recovery and our recovery is critical to the resolution of the international debt problem."

(2) Mr. Hormats noted that "International trade issues, financial matters and questions of domestic economic growth and employment are generally addressed separately, with little understanding of, or attention to, the implications of actions in one area on the others." He was joined by other witnesses in calling for greater international coordination of policies between governments, multilateral institutions, and private lending institutions.

(3) Witnesses stressed the need for greater understanding in the United States about the economic ties of this country to the rest of the world. It was noted repeatedly that we now export 10 percent of our GNP (double that of 10 years ago) and that 40 percent of our exports now go to the LDCs.

(4) There was unanimous agreement that additional resources for the IMF are required. Witnesses noted that the Fund has played a critical "intermediary" role in a number of recent debt crises, including that of Mexico. Most witnesses rejected the contention that additional funds for the IMF would constitute a commercial bank "bail out" noting that commercial banks were being asked to put more funds into countries receiving IMF assistance.

In addition to expanded IMF resources there was a general recognition of the need for continued commerical bank international lending during this critical period, as well as increased multilateral and bilateral aid flows.

(5) Although there was general agreement that the huge short term debt of the LDCs had to be restructured into long term loans that were at lower interest rates, there were conflicting recommendations on how to accomplish this goal. Felix Rohatyn supported a "write down" plan in which commercial bank loans would be assumed by one or more multilateral agencies in order to meet the need for a long term low interest rescheduling of existing LDC debts. Mr. Ogden, although in agreement on the need for some sort of an "asset exchange system" did not feel that the creation of a new institution would be necessary. Mr. William Cline of the Institute for International Economics argued that long term solutions had to incorporate the replacement of commercial banks "as the principal vehicle for capital flows to the developing nations." There was no consensus regarding the need for improved regulation of the international lending practices of the commercial banks, although the need for such regulations was suggested by Senator Proxmire.

(6) Most witnesses supported the thesis that exchange rate fluctuations, including an overvalued dollar, have distorted trade balances and weakened the investment climate. There was general agreement that some kind of stabilization of the main trading currencies would be a necessary part of any resolution of the current global economic problems. Although no one advocated a return to the fixed exchange rate system, several witnesses supported a system whereby rates would be maintained within certain agreed-to bands or ranges of growth and contraction.

(7) On the subject of trade barriers and other protectionist measures, the Subcommittee's witnesses were nearly unanimous in their opposition. Various proposals were suggested to improve GATT's dispute settlement mechanism, and to expand GATT's framework to include trade measures which have not come under its provisions or regulations. As Robert Hormats testified "Well over half of world trade today is subject to some type of government support or intervention, and that figure is on the increase. The immediate issue, therefore, is not a theoretical debate between free trade and protectionism but how to prevent an escalating series of import barriers and subsidies with countries retaliating against, or emulating, one another."

UNITED STATES SENATE,
COMMITTEE ON FOREIGN RELATIONS,
Washington, D.C., February 18, 1983.

Memorandum to: Members, Committee on Foreign Relations.
Thru: Ed Sanders and Jerry Christianson.
From: Cas Yost and Janice O'Connell.
Re: Secretary of the Treasury Donald Regan Testimony.

The Foreign Relations Committee will hold a hearing on Wednesday, February 23, at 10:00 a.m. in Room SD-419 to hear testimony from Secretary of the Treasury Donald Regan on Administration proposals for legislation to increase the resources of the International Monetary Fund (IMF). Secretary Regan will also comment on Administration funding requests for the multilateral development banks.

BACKGROUND

Between 1973 and the end of 1982 total external debt of the Lesser Developed Countries (LDCs) increased five hundred fold to roughly $600 billion. Much of this debt was contracted at a time of high inflation and low real interest rates. The recession in the West, the precipitous drop in commodity prices and the rapid rise in real interest rates have created serious liquidity problems for a number of countries. Mexico, Brazil and other major borrowers have, in recent months, been unable to service their debts. A number of developed countries, including the United States, have provided emergency bridging loans to beleaguered countries. In addition, these countries together with the IMF and the private commercial banks have developed financing packages for a number of economically troubled countries to meet the short-term requirements.

In the process, concern has arisen that the resources of the IMF are nearly exhausted, and may not be sufficient to meet future foreseeable requirements. Increases in IMF resources were agreed to by member governments under the auspices of the Interim Committee Meeting of the Board of Governors on February 11. The quota increase will not be submitted for the necessary legislative approval process in each country including the United States.

INTERNATIONAL MONETARY FUND

The IMF was founded after World War II to promote a stable world monetary framework. Its functions include: providing temporary balance of payments financing in support of national economic adjustment policies, monitoring members foreign exchange arrangements and economic policies, tracking the adequacy of international liquidity and promoting member government cooperation within the international monetary system.

The IMF obtains funds to finance members temporary balance of payments needs through quota subscriptions and borrowings from members.

The lending of the IMF is "conditional" on the willingness of recipient nations to adopt a domestic economic program designed to promote orderly adjustment and a restoration of economic health. The borrowers agreement with the IMF often serves as an incentive for other lenders to participate in assisting a financially troubled country.

AGREED INCREASES IN IMF RESOURCES

Member governments agreed to an increase in IMF quotas of 47.5 percent, an increase from Special Drawing Rights (SDR) 61 billion to SDR 90 billion (current dollar equivalent from $67 billion to $99 billion). The proposed increase in the U.S. quota is SDR 5.3 billion ($5.8 billion) representing 18 percent of the total increase.

In addition, agreement was reached for an expansion of the IMF's General Arrangements to Borrow (GAB) from the equivalent of about SDR 6.5 billion to a new total of SDR 17 billion. Access to the GAB has been limited to the Group of Ten (industrial countries), but it was also agreed to expand access to the GAB to permit emergency drawings on the IMF by any member country. The U.S. commitment, under this agreement, to the GAB will increase by an additional $2.6 billion from a current level of $2 billion.

CONGRESSIONAL ACTION

The Administration will shortly present legislation to Congress requesting a total of $8.4 billion for the IMF. Both the increase in the U.S. quota and the increase in the U.S. commitment under the GAB will require authorization and appropriation by the Congress. However, because the United States receives a liquid, interest-earning reserve claim on the IMF in connection with our actual transfers of cash to the IMF, such transfers do not result in net budget outlays or an increase in the Federal budget deficit.

ARGUMENTS AGAINST QUOTA INCREASES

Critics of proposed increases in U.S. contributions to the IMF have termed it a "bailout" of commercial banks which over-extended themselves to certain countries in the 1970's and early 1980's. According to the Federal Reserve, between mid-1980 and mid-1982 the claims on Mexico of the nine largest U.S. banks grew from 32 to 50 percent of capital funds, with lending terms tightening only toward the end of that period.

Some critics have argued that these resources might better be utilized in the United States at a time when 12 million Americans are unemployed and domestic programs are being reduced by budget cuts.

Others have expressed concern that the size of the increase could make the IMF so flush with funds that should the world economy improve, the IMF would be tempted to lend excessively and unwisely.

Finally, from a different perspective, other critics argue that the "conditionality" of IMF programs is so severe that negative political repercussions are sure to ensue in one or more countries receiving IMF assistance and that as a condition of providing resources to the IMF, this conditionality should be moderated.

ARGUMENTS IN FAVOR OF QUOTA INCREASE

Proponents of the quota increase argue that a number of countries, including Mexico and Brazil, with which the United States has important economic links, are facing severe liquidity problems. Mexico is the third largest market for U.S. exports and therefore, serious repercussions were felt domestically when U.S. exports to Mexico dropped by a staggering 60 percent between the fourth quarter of 1981 and the fourth quarter of 1982. If the IMF is to continue to be a key player in efforts to revive the economy of Mexico and the economies of other major debtor nations, it must have adequate resources.

They assert that rather than bailing out the banks for imprudent lending, the IMF has in fact, elicited additional bank lending, greater than the amount disbursed by the IMF itself. Indeed experts agree that if Mexico and other debtor countries are to regain economic strength, more commercial bank lending will be required.

Finally, proponents argue that it is in the U.S. interest to support an increase since the United States has been a major borrower from the IMF in the past and could be in the future. The United States has drawn on the IMF on 24 occasions—most recently in November 1978—totalling some $6.5 billion and is the second largest user of IMF resources.

CONGRESSIONAL OPTIONS

Even members of Congress, who have historically supported increasing in IMF resources, have expressed concern about the extent to which commercial bank lending to financially troubled foreign countries has brought about a situation where increases in IMF resources now appear imperative if the system is to remain solvent. This concern is intensified (and complicated) by the realization that assisting these countries is likely to involve even greater levels of commercial bank credit extension. This has led some to suggest that measures must be adopted to ensure that American banks do not become so over-extended again. These measures include the following:

Establish "country limits" for each bank's exposure to a given country which would be analogous to the "single borrower" limits in effect at present.

Require banks to establish specific loan loss reserves against troubled loans to foreign borrowers.

Require more complete disclosure of the size, distribution, terms, and status of a bank's foreign exposure.

Require closer coordination or surveillance over sovereign risk lending by national bank regulators or some international authority such as the IMF.

Multilateral development banks

In addition to the requested increase in IMF resources, the Administration will also be seeking new authorizations of appropriations of $1.2 billion for replenishments of a number of the regional development banks. The following is a brief description of the institutions involved and the contemplated sizes of the replenishments.

IDB General Capital Increase (GCI).—The United States is in the final stages of negotiating the sixth replenishment of the InterAmerican Development Bank's (IDB) ordinary capital window. This window provides loans at near market rates of interest to Latin American members of the Bank. The proposed increase in the capital account will be on the order of $14.8 billion, of which the U.S. share will provide $5.16 billion (34.5 percent of the total). U.S. contributions will be provided in four equal yearly installments of $1.29 billion beginning in fiscal year 1984, of which only 4.5 percent of the subscriptions will be in the form of paid-in capital ($58 million annually) and thus will require appropriations. The remaining $1.23 billion of the annual installment will be in the form of callable capital, and not subject to appropriations, but rather dealt with as a program limitation in appropriations acts.

IDB Fund for Special Operations (FSO).—Negotiations are also nearly concluded on the replenishment of the Fund for Special Operations (FSO)—the soft loan window of the IDB which provides loans on highly concessional terms to the poorest countries of the region. The total replenishment will be on the order of $725 million to be contributed over a four year period beginning in fiscal year 1984. This is down considerably from the last replenishment of $1.75 billion. The U.S. contribution will equal 40 percent of the total (the same share as the last replenishment) and require annual contributions of $72.5 million to be fully appropriated.

InterAmerican Investment Corporation (IIC).—The Administration is also proposing that the U.S. participate in a newly created institution, the InterAmerican Investment Corporation (IIC) which is modeled on the International Finance Corporation (IFC)—a member of the World Bank Group. The IIC will provide development assistance to the private sector of Latin America. As currently constructed the United States will provide subscriptions of $20 million annually over 4 years—this may end up being as much as 40 percent of total subscriptions. These funds will require full appropriation. Venezuela will also provide $20 million annually. The final details of other subscriptions has yet to be completed.

Negotiations on the total IDB package (GCI, FSO and IIC) may be completed by the end of February, with legislation submitted shortly thereafter.

The Asian Development Bank (ADB).—The ordinary capital window of the Asian Development Bank (ADB) is also the subject of replenishment negotiations, which the Administration hopes to conclude within the next 2 months. The ADB provides loans at near market rates of interest to its members in the Asia and Pacific regions. Currently the replenishment size is still uncertain but will be somewhere on the order of $7.1 to $8.7 billion. (The last replenishment totalled $5.0 billion with the U.S. share $814.3 million paid over 4 years.)

The U.S. share of this latest replenishment is likely to remain the same as the last replenishment—16.3 percent of the total. The U.S. share of the total capital increase will be between $900 million and $1.2 billion, and will be paid in four equal annual installments beginning fiscal year 1984. At least $7 million annually will be in the form of paid-in capital requiring appropriations (if the United States is able to sustain its position of only 3 percent of the total increase being in the form of paid-in capital) with the remaining portion as callable capital to be treated as a program limitation in appropriation acts.

Asian Development Fund.—The Administration has concluded negotiations on the Asian Development Fund (ADF) replenishment. The ADF provides assistance on highly concessional terms to the poorest of its members in the Asian and Pacific regions. The replenishment is to total $3.2 billion, of which the U.S. contribution will be $520 million (16.25 percent of the total) to be paid in four annual installments of $130 million beginning in fiscal year 1984. These funds must be fully appropriated. The last replenishment totalled $2.150 billion. The U.S. share of total was 20.7 percent or $445 million.

African Development Fund (AFDF).—The Committee will also be required to consider for the second time, the third replenishment of the African Development Fund (AFDF) which was considered by the committee during the 97th Congress and passed the Senate, but failed to be acted upon by the House. The AFDF provides highly concessional assistance to the poorest members in the region of Africa.

This replenishment totals $1.06 billion, of which the United States is to provide $150 million (14.2 percent of the total). The U.S. contribution is to be appropriated in three annual installments of $50 million. Appropriation of the first $50 million is already provided for in the fiscal year 1983 continuing resolution passed last December. The last replenishment was $758 million of which the United States provided $125 million (16.5 percent of the total).

UNITED STATES SENATE,
COMMITTEE ON FOREIGN RELATIONS,
Washington, D.C., April 11, 1983.

Memorandum to: Members, Committee on Foreign Relations.
Thru: Ed Sanders and Jerry Christianson.
From: Janice O'Connell and Cas Yost.
Subject: Hearing on the International Financial System.

The Subcommittee on International Economic Policy will hold its seventh hearing on the state of the international financial system. The hearing will take place on April 13, 1983 at 10:00 a.m. in SD-419. The Committee will receive testimony from: Mr. Henry Schechter, Director, Office of Housing and Monetary Policy, AFL-CIO; and Mr. William L. Hoppe, Manager of Economic Studies, Bethlehem Steel Corporation, Speaking on behalf of Americn Iron and Steel Institute.

The Subcommittee has held extensive hearings on the current state of the world economy and its implications for developed and developing countries. To date, the witnesses representing the Administration, the banking community, and the academic community have shared their views on this subject. Past hearings have focused on the damage to the international monetary system resulting from the current economic recession. These hearings have analyzed the impact of mounting and increasingly unmanageable external debts accumulated by the developing countries and provided recommendations as to how policy makers might manage the crisis in the short term and prevent such a situation from recurring in the future. Witnesses have endorsed U.S. participation in the 47 percent increase in IMF quotas and the expansion of the General Arrangements to Borrow (GAB).

Wednesday's hearing will focus on a slightly different aspect of the current problem. The representatives from the AFL-CIO and the Iron and Steel Institute will provide an assessment of what the current international economic environment has meant for American labor and American industries and in that context will provide the Committee with their views on the wisdom of increasing U.S. participation in the IMF.

BACKGROUND

Following the first oil shock in 1973-74, developing countries (LDCs) began to rapidly increase their international borrowing. Some smaller countries encountered problems servicing this debt throughout the decade, but in the last year, real or potential difficulties of several major LDCs, including Mexico, Argentina, Brazil, and Venezuela, have raised concern about the overall exposure of the private banking system and the ability of official multilateral mechanisms to deal with a financial crisis in one or more of these countries. These countries have been hard hit by high real interest rates and decreased export earnings, making debt servicing much more difficult.

Slow growth is serious problem

The current problems of the international financial system are symptoms of the decline in economic growth particularly in the economies of the developed world. The OECD countries are in the midst of the deepest and longest recession in the Post War period. Unemployment, which has resulted from the recession, has reached 32 million in the OECD countries—including 12 million unemployed in the United States—with an additional 2 million workers likely to be added to the unemployment figures by the end of 1983. Capacity utilization in the manufacturing sectors of the industrialized world has reached its lowest levels since the Great Depression—in the United States, only 68 percent of existing manufacturing capacity is currently being utilized.

Implications for the industrial countries

The pessimistic outlook for economic development in most LDCs is a matter of concern for industrial countries. From a strictly humanitarian point of view, we can expect increased refugee problems and illegal migration, both within the Third World and between the Third World and industrial countries. Slow economic growth, particularly in the poorer countries, combined with a rapidly increasing labor force, obviously means that part of that force will seek employment in other countries.

From an economic perspective, slower growth in the LDCs will mean that their demand for products from the industrial countries will decline. For example, IMF programs for Argentina, Brazil and Mexico require those countries to reduce their collective balance of payments deficit in 1983 as compared to 1982 by $10 billion. In 1981 the United States, a major supplier to those countries, registered exports of $24 billion. That level of exports will not be sustained under new austerity programs. (Some observers have noted, however, that to the degree that IMF programs can reduce the probability of financial collapse, they will have a long term beneficial impact on trade.) Certain high technology industries such as aircraft, machine tools and stagnation in the economies of the developed world, will suffer further from the decline in LDC demand.

In addition, the much publicized problems of Mexico, Agrentina, and Brazil (which together have about $200 billion of the debt) have excited fears in the market place with respect to the over-exposure of many of the largest commercial banks to weak economies. The LDCs must service a debt burden which in aggregate is estimated (medium and long term) to be over $500 billion in 1982. Their ability to service this debt is made more difficult by the hesitancy of certain commercial banks to advance additional funds or roll over existing debt as it comes due.

In this atmosphere, questions are being raised about the capacity of the existing institutions—national and multinational—to cope with these problems. Some observers point to the gap between the long term lending efforts of the World Bank and the short term balance of payments adjustment approach of the IMF. Concerns are also raised with respect to the relatively unregulated nature of commercial bank sovereign risk lending.

U.S. position

In the past, the U.S. economy has been the engine of economic recovery in times of economic stagnation elsewhere in the world. This may still prove to be the case, but it is also increasingly evident that U.S. economic prosperity is linked to economic growth in other countries.

Exports currently account for approximately 10 percent of U.S. GNP, more than double 10 years ago. Twenty percent of U.S. industrial output is exported. One of every six U.S. workers in the manufacturing sector produces for export. Significantly, between 1977 and 1980 four out of every five new jobs created in the U.S. manufacturing sector were export related. In addition, two out of every five acres of U.S.

farmland produce for export. Finally, approximately a third of all U.S. corporate profits come from companies' international activities.

The United States, in short, has developed a very sizable stake in the global economy. Moreover, it's stake in LDC markets is particularly important. At present, the United States sells more to the developing world than to Japan and the EEC combined. Our third largest trading partner, at present, is Mexico. Reduced Mexican imports are inevitably going to be felt in the U.S. domestic economy.

AFL-CIO position

The Executive Council of the AFL-CIO adopted a number of policy statements during the course of its February meetings in Bal Harbour, Florida. Among these statements was a conditional endorsement of U.S. participation in the increase in IMF resources provided that commercial banks be required to share some portion of the cost of "rescuing the system" and that in the future bank regulators more closely supervise private bank lending. However, they did express concern over the adoption of certain IMF economic stabilization programs which tended to drastically reduce the imports of these financially troubled countries and so reduced markets for U.S. products. They took note of the current financial chaos internationally and noted the particularly destructive role that widely fluctuating exchange rates had played in furthering inflationary pressures. In addition, the Council called upon participants of the forthcoming Williamsburg Economic Summit to develop economic policies which will lead to domestic and international recovery (copies of statements are attached).

STATEMENT BY THE AFL-CIO EXECUTIVE COUNCIL ON INTERNATIONAL MONETARY FUND, FEBRUARY 24, 1983

The current international debt crisis requires far-reaching and comprehensive arrangements based on close cooperation of all the countries concerned. Piecemeal measures which aim primarily at alleviating the current crisis will not prevent further proliferation of potential defaults.

Congress has been asked to approve United States participation in a 40 to 50 percent expansion of the International Monetary Fund, of which the U.S. share would be about $8 billion. This would be in addition to an expansion of the General Agreements to Borrow (GAB) special IMF fund, which requires about a $2 billion U.S. participation.

Such an expansion of IMF lending authority is being proposed to help greatly indebted nations, such as Mexico, Brazil and Argentina, with further credit extensions so that they do not have to default on large outstanding debts.

The creditors are not just sovereign countries, but also, to a very large extent, private, U.S. and foreign banks. Although the banks and the IMF might, in the immediate future, have to extend more credit to the debtor countries, they would in the long run avoid losses of large sums of money presently owed to them.

The Federal Reserve Board and the central banks of other countries have largely surrendered to the commercial banks the responsibility for oversight and control of international lending.

When the IMF extends credit to hard-pressed debtor nations, it usually requires that certain conditions be met by the assisted country, cutbacks in social programs, tight monetary policies and the adoption of policies to increase exports and decrease imports, so that foreign exchange gains can be made to help repay debts. In the process, trade and employment are injured in the United States as well as in all free world nations.

The AFL-CIO recognizes the serious consequences of potential large debtor nation defaults to the world economy and the need for IMF action to help debtor nations out of their precarious positions. It also recognizes, however, the cost in dollars to the U.S. taxpayers and in jobs to U.S. workers.

The AFL-CIO supports U.S. participation in an expansion of IMF capital funds, provided that legislation is enacted to accomplish the following:

The IMF should require private banks that have extended loans to foreign borrowers to share in the costs and burdens of any "rescue" efforts.

IMF resources should not be used to reschedule and recycle the debts of totalitarian regimes and those that abuse human rights.

The Federal Reserve Board should be required to increase reporting and surveillance of U.S. bank foreign lending and to restrict such lending, with due consideration of the impact of credit availability and cost to the U.S. economy, as well as the capability for repayment.

The Federal Reserve Board should be directed to require special U.S. bank reserves against foreign lending, and such reserves should be available to provide a part of future U.S. contributions to IMF fund expansion.

The Federal Reserve Board should be required to report regularly to the Congress on the volume and terms of foreign credit extension by U.S. banks, on the quality of such credit, and on the effects of such credit extension upon the U.S. economy with respect to international trade positions and the availability and cost of credit in the United States.

The Secretary of the Treasury should be directed to seek change in IMF policies to reduce emphasis upon the development of excesses of exports over imports and to place more emphasis upon balanced economic growth through development of broader domestic markets and improved income distribution.

Statements Adopted by AFL–CIO Executive Council

MINIMUM WAGE

Inflation has sharply eroded the value of the minimum wage. Since January 1978, when the Congress set the minimum wage at $2.65, the minimum wage went up in steps to $3.35 an hour—an increase of 26 percent. But the cost of living has increased by 56 percent. To match the buying power of $2.65 an hour, the minimum wage today would need to be $4.14 an hour.

America's lowest-paid working families are suffering severe economic hardship and the loss of their purchasing power plays a part in deepening and prolonging the present recession.

Instead of urging an increase in the minimum wage to protect the neediest workers in America, the Reagan Administration has recommended a $2.50 an hour subminimum for workers under the age of 22 each year from May through September. A youth paid $3.35 an hour during the past two summers would be paid only $2.50 an hour this summer for the same work.

The subminimum proposed by the President would base a worker's wage on age, rather than on the value of the work performed. It would encourage the replacement of poor adult workers with subminimum wage youth, many of whom are from higher income families.

The youth subminimum has been rejected many times, most recently by the Minimum Wage Commission in 1981. There is no evidence that such a scheme would increase job opportunities.

The AFL–CIO urges Congress to reject the President's proposal for a subminimum wage for youth and, instead, to take the minimum wage in the direction it should go: toward the restoration of the purchasing power lost by America's lowest-paid workers.

JOB TRAINING

Plant closings, major layoffs, worker dislocations and shifting skill requirements vastly increase the need for an effective national job training effort to supplement job-creation programs.

National employment and training policy must fully address the retraining and relocation needs of displaced and disadvantaged workers. In order to help older workers who face discrimination in obtaining training and new jobs, the Age Discrimination Act must be effectively enforced.

The recently enacted Job Training Partnership Act, now the vehicle for this nation's meager job training efforts, calls for cooperation among labor, employers and government at the Federal, state and local level in planning and operation of training programs. Federal funding for training under JTPA, especially the dislocated worker program, should be greatly increased.

The AFL–CIO rejects Administration proposals to raid depleted unemployment insurance funds for money to provide education or training vouchers for jobless workers. We urge Congress to establish clearly the right of all persons drawing unemployment insurance benefits to enroll in approved education and training without losing their benefits. Some states now allow such enrollment but Congress should guarantee this opportunity to unemployed workers in all states.

The AFL–CIO calls for effective labor participation in JTPA programs with full labor representation on local Private Industry Councils and State Job Training Coordinating Councils. We also urge AFL–CIO-affiliated organizations to participate in planning and operating JTPA programs in their communities to make sure that Federal training funds will help participants acquire useful skills and obtain decent jobs. In this effort we urge affiliates to use fully the technical resources of the AFL-CIO Human Resources Development Institute.

UNITED WAY LABOR POLICY

Organized labor continues to make major contributions in support of the United Way recognizing that the dollars donated by union members effectively assist today's victims of the Reagan recession.

At the AFL-CIO Fourteenth Constitutional Convention, resolutions were submitted calling for the withdrawal of support for the United Way if that agency did not take steps to adopt and implement a national labor policy for itself and its affiliates. These resolutions were referred to the AFL-CIO Executive Council for study by an ad hoc committee to be named by the President.

The ad hoc committee appointed following the 1981 convention reports the following progress:

The Board of Governors of the United Way of America, on May 20, 1982, adopted a national labor policy that promises to protect the rights of employees to organize and to respect their collective bargaining contracts and equivalent understandings. It urged local United Ways to have such a labor policy and to recommend the adoption of similar labor policies by their participating agencies.

In the 9 months since this action, 175 local United Ways in 35 states, including most of the major urban areas of the country outside of the South, have adopted such a policy. We applaud this action.

The AFL-CIO calls upon the United Way of America, the Federation's Community Services Department, its state and city central bodies and its national and international affiliates to continue to press for the adoption of this policy in communities where no action has been taken. We urge affiliates with concentrated membership in communities that have not acted, to place special emphasis in these areas and, where this policy has been adopted to monitor its implementation.

The United Way ad hoc committee shall receive periodic reports from the Community Services Department on the progress of these efforts.

If the committee determines that sufficient progress is not forthcoming in communities throughout the country, the committee shall re-examine the need for additional steps to be taken to bring about the improved labor relations climate sought by the AFL-CIO.

1983 ECONOMIC SUMMIT

The seventh annual summit conference of the leading industrialized nations, which will take place in the United States in May, is a challenge to the Reagan Administration and the other six industrialized nations to develop domestic and international economic recovery policies which are essential to reinforce individual national efforts.

The worsening world economic, financial and monetary crisis underscores the great need for international economic measures and agreements, especially among the industrialized nations.

The summit meeting of the seven leading industrial democracies must not be used once again for the repetition of cliches instead of joint effort to solve critical economic issues.

The AFL-CIO has proposed to previous summit meetings, both through the Trade Union Advisory Committee to the Organization for Economic Cooperation and Development and through our own recommendations, a whole set of policies concerning jobs, investment, energy, industrial reconstruction, international trade and development. The alarming events of the last few months demonstrate the need to address unsolved international financial issues.

TUAC has long called for comprehensive negotiations and cooperation among the industrial democracies, and between them and the developing countries, on concerted and mutually complementary economic, financial and trade policies to bring about world economic recovery.

More than 30 million people, over a third of them Americans, are unemployed in the OECD area. TUAC has estimated that unless an internationally coordinate recovery is achieved, the number of the unemployed is likely to rise to 40 million by the end of this year.

The international monetary chaos is one of the major factors of this protracted and worsening economic recession and has reached a point where it can undermine the policies pursued in any other sector of the world economy.

The present system of floating exchange rates undermines international cooperation in the monetary field and contributes to inflation, especially through the volatile fluctuations of the exchange rates. Currency warfare has thus been added to trade warfare as one of its strategic elements.

If the IMF goes on indiscriminately imposing on the debtor countries drastic reductions of their imports, the industrial countries, from which the finance for the rescue operations must ultimately come, one way or the other, will lose export markets. About one-third of American exports go to the developing countries; moreover, it is in these countries that the badly needed expansion of the export markets can most easily be achieved.

No nation can return to prosperity alone. There must be equitable international burden-sharing based on jointly spelled-out monetary, fiscal, industrial, investment, energy and employment policies. These policies should be developed through appropriate machinery involving labor, management and government.

NATURAL GAS

One of the most pressing energy issues facing the 98th Congress is the current explosion in natural gas prices. Today's unaffordable and totally unjustified gas prices are stifling economic recovery and devastating individual households.

The AFL-CIO remains strongly opposed to the deregulation of natural gas prices, both to the current schedule of phased deregulation and to all attempts to accelerate decontrol.

While there have been proposals to develop and transmit to the lower states gas from the ample supplies on Alaska's North Slope, no action has been taken. Instead, private interests are pressing for abrogation of the commitment to reserve North Slope petrochemical products for U.S. consumption and to permit their sale abroad.

The only beneficiaries of deregulation are the gas producers, who are not only receiving enormous profits but also have imposed "take-or-pay" contract provisions which force pipeline companies to buy the highest-cost gas even when lower-priced gas is available. The AFL-CIO believes that effective controls must be reinstated to protect consumers from the monopolistic position and structure of gas producers and pipelines.

Although the phase-out of controls is raising prices rapidly, the Reagan Administration is working to raise prices even more sharply through administrative actions by the Federal Energy Regulatory Commission and through legislative proposals to accelerate the rate of deregulation. In the latest of many such moves, the FERC in January allowed producers to add $3 billion in costs on top of current prices, even though prices were already high enough to cover producers' costs and give them tremendous profits. Accelerated deregulation would add tens of billions of dollars more to the nation's fuel bill.

The AFL-CIO urges Congress to roll back prices and extend price controls, reject any accelerated phaseout, prohibit unjust "take-or-pay" contract provisions, and prevent the FERC from taking unjustified administrative steps to increase gas prices.

To help achieve energy independence we also support the construction of a natural gas pipeline to bring North Slope natural gas to U.S. markets, and oppose any plan to export Alaskan natural gas.

U.S. POLICY OPTIONS ON POLISH SANCTIONS [1]

(By John P. Hardt and Donna Gold, Congressional Research Service, January 3, 1983)

THE POLICY ISSUE

Poland, the United States, and the West all recognize that Polish political stability and economic recovery are contingent upon the establishment of domestic social consensus and resumed access to Western trade and credit markets. The most efficient means for attaining these objectives, however, remains a source of disagreement.

---

[1] Based in part on interviews by John P. Hardt in Warsaw, Poland in December 1981, before martial law was instituted, and December 1982, before martial law was suspended. The Chro-

Among the Western countries there are differing opinions as to whether or not the substance of formal Polish commitments are the same or perhaps even the reverse of what the Western governments perceive as necessary and appropriate. This difference of opinion brings into question the relationship between stated and actual Polish performance. Following the imposition of martial law, U.S. policy seemed to be based on the assumption that Polish leaders were irreconcilably opposed to meaningful reform and insincere about their official commitment to renewal. There was a feeling among policymakers that the Polish Government should be punished—forced to "pay a price" for repression. Some felt that this economic price was also a direct cost to the Soviet Union, which they considered the dictator of Polish policy.

With Jaruzelski's suspension of martial law and willingness to conform to conditions laid out by the United States (the release of detainess, a resumed dialogue between the Government, Church and a free trade union), a different policy approach now seems to be in order. The President has recently indicated some desire to tie reciprocal economic ties to improvements in Polish human and civil rights. On December 10, 1982 he said that "if the Polish Government introduces meaningful liberalizing measures, we will take equally significant and concrete actions of our own." An effective dialogue between the State, the Catholic Church, and a free trade union would be one such improvement. Polish leaders and professional specialists acknowledge that favorable economic relations with the United States and the West are crucial to regaining domestic economic health and foreign economic solvency. In addition, Western relations offer another benefit—provide a sense of legitimacy to a very tarnished government. Western normalization that includes a degree of acceptance by the Pope—a visit in itself provides a measure of acceptance—might allow Jaruzelski to govern by acceptance rather than solely by power and coercion.

A reciprocal policy approach to the Polish situations has long had much appeal among West European governments and opinion centers. Supporters of this policy feel that Western reciprocal action would strengthen those forces in Poland dedicated to renewal and reform while ensuring Jaruzelski a useful degree of room to maneuver between Polish and Soviet leadership objectives. Moreover, a reciprocal policy appears to provide the West with more leverage for narrowing the gap between Polish stated objectives and actual performance.

Assuming that the United States continues to move with the Europeans in the direction of a reciprocal policy, the appropriate questions to ask are:

How can United States policy be most effective in stimulating substantial compliance on the part of General Jaruzelski to his professed commitments to renewal and reform that we appear to share?

Would such a policy provide a future basis for a unified Western approach to likely changes in Polish action?

If the United States and Western Europe decide to follow different policies with respect to Poland—the United States a punishment policy and Western Europe a reciprocal policy—Western unity could be disrupted, as it had been during the "pipeline" sanctions.

BACKGROUND

Martial law has been suspended as of December 31, 1982. Since its imposition over a year ago, NATO, the OECD, the United States and individual Western countries have taken steps to register disapproval on the suspension of human and civil rights in Poland and to encourage the revival of the favorable political and social environment experienced during the Polish renewal period (August 1980-December 1981). General Jaruzelski has formally reaffirmed his promise of continued commitment to Polish renewal even under martial law and has made an additional commitment to economic reform. Many note that recent laws restricting civil rights and providing for "short-term" recentralization of the economy juxtapose liberal rhetoric and reactionary actions.

Severe economic problems in Poland contributed to social unrest in August 1980. A further rapid decline in the performance of the economy, resulting in the inability of the Government to meet its foreign debt obligations, weakened the credibility of the Polish Communist Party and exposed the Party as politically ineffective and

---

nology draws especially from material supplied by the U.S. Embassy in Warsaw. Interviews in Berlin, Bonn and Cologne were also used in this report.

corrupt. This situation contributed to the establishment of an independent trade union movement (Solidarity) and a political process of change referred to as "renewal" (obnowa).

The installation of General Wojciech Jaruzelski as Chief of State, Commander of the Armed Forces, and leader of the Polish Communist Party represented an effort to gain control of the deteriorating political and economic situations in Poland. The institution of martial law at midnight on December 12, 1981 indicated that confrontation not accommodation was the immediate answer to the perceived crisis. Whether this policy can be revised and a return to accommodation achieved remains to be seen. Some moderation in martial law occurred in July 1982. However, rising numbers of demonstrations for Solidarity in August led to the tightening of controls and Soviet warnings. In October 1982 Solidarity was disbanded and replaced by a new trade union charter.

The dominant problems for the Jaruzelski government in the short-run are economic recovery and political stability: With the spiral downward in economic performance arrested, will the production of goods and services increase? Will Western debts be serviced, new loans obtained, and favorable hard currency trade balances regained? Possibly, but not necessarily. Formal default has been avoided to date. Western governments and commercial banks have rescheduled the payment of principal and interest due for 1981. Commercial rescheduling for 1982 has been agreed to, but government debt rescheduling has not yet been discussed.

The prospects for Poland's evolution are clouded by the continuing uncertainty of Soviet intentions. The possibility of direct Soviet military intervention remains. Although a Soviet military move against Poland would be enormously costly to Moscow and would create a crisis of the first order in Eastern Europe and in East-West relations, it can never be ruled out.

The U.S.S.R. shares an interest with the United States, Poland and the West in a revived, healthy Polish economy and foreign economic solvency. The U.S.S.R. may therefore be flexible on systemic changes inherent in continued renewal and reform, if Polish economic programs are successful. It is important to recall that during the premartial law period, the Soviet Union encouraged the repayment of Polish debt and assisted the reform regime by providing implicit subsidies, including the deferment of debt payment to the U.S.S.R. and additional deliveries of Soviet oil at prices below those of OPEC. Soviet policy seems to have been more favorable when Polish political actions moved away from Soviet norms.

THE POLISH LEADERSHIP'S COMMITMENT TO RENEWAL AND REFORM

On December 13, 1981 General Wojciech Jaruzelski proclaimed martial law and rule by a 21-man military council of national salvation. The martial law decree "suspended" basic civil rights and the independent Solidarity trade union [banned strikes, independent political activity, public gatherings, demonstrations, domestic and foreign travel, and dissemination of all publications and information], introduced a curfew, closed down all communications, and interned or arrested Solidarity activists, advisers, dissidents and others whose loyalty to the military regime was suspected. At the same time, Jaruzelski promised the continuation of post-August 1980 reforms and the preservation of the basic features of Socialist renewal.

Some steps were taken to introduce pluralism into the political system during the year of martial law. The legislative process in the parliament, the Sejm, was enhanced (See Table 1). Parliamentary debates, including national economic debates, were widely reported in the press. Parliamentary representation took on a more multiparty nature, including additional Catholic delegates. The Sejm was further accorded an audit function.[2]

---

[2] "It is already a truism that the activity of the Sejm . . . is a kind of barometer of the general climate and pulse of political life in (Poland). Just as intensification of its activity and an expansion of its role in the system is an expression of accelerated social change and democratic development, so too a waning of the Sejm's activity and a diminution of its authority is a symptom of stagnation and set backs in the development of social and political relations." Quoted from Zdzislaw "Jarosz, Panstwo; Prawo" No. 89, 1976 Sarah Meiklejohn Terry, "The Sejm as Symbol: Recent Polish Attitudes Toward Political Participation" in "Background to Crisis: Policy and Politics in Gierek's Poland" edited by Maurice D. Simon and Roger E. Kanet (Colorado: Westview Press), 1981, pg. 27.

TABLE 1.—*Sejm legislation relating to reform* [1]

1. Decrees on Economic Reform in Poland: System-Related Targets and First Experience.
2. Law on State Enterprises of September 25, 1981.
3. Law on Self-Government of Personnel of State Enterprises of September 25, 1981.
4. Law on Socio-Economic Planning of February 26, 1982.
5. Bank Law of February 26, 1982.
6. Law on the Statute of the National Bank of Poland of February 26, 1982.
7. Law on Licences to Carry Out Foreign Trade Operations of February 26, 1982.
8. Law on Principles of Conducting an Economic Activity in Small Industry by Foreign Corporate Bodies and Private Persons in the Territory of the Polish People's Republic of July 6, 1982.

[1] Polish Chamber of Foreign Trade, "Economic Reform in Poland" (Materials and Documents), Warsaw, 1982.

Solidarity was disbanded in October 1982 and replaced by a "free" trade union. According to Polish authorities, this union conforms to the principles recognized by the International Labor Organization [ILO]. The ILO, on the contrary, found the new Polish trade union charter incompatible with the freedom of association provisions of the ILO charter (Convention 81). This issue will be reexamined by the ILO in February-March of 1983 to consider the need for a Commission of Inquiry.

After a year of martial law, Jaruzelski reaffirmed his commitment to the irreversibility of renewal and continued reform: "One year ago I said: 'I want to achieve one thing, peace'. I promised anarchy would be stopped and the dangerous chaos would be overcome. Today, everybody can work without the strike terror. Today, the streets of Polish towns are safer.

"I promised to halt the economy's disintegration and to revert the downward trends. Despite enormous obstacles and difficulties, we have been recording a slight but steady growth in output for some months now.

"We have entered the phase of setting our economic life in order and of introducing reforms.

"I promised the line of reform would continue. The laws passed by the Sejm this year and the many innovative methods and solutions have confirmed that we are making the process of renewal irreversible." [3]

Discussions with the Primate, Archbishop Glemp, became more frequent in the Fall, 1982. The Church called for peaceful protest and a revival of Solidarity. A visit of Pope John Paul II to Poland was publicly announced for June 1983. Lech Walesa was released from detention but restricted in his freedom of action, as especially evidenced by his inability to make his speech commemorating the anniversary of the 1970 worker protests on December 16 in Gdansk.

Although martial law has been suspended, many of its features has been retained by new punitive legislation. Such legislation includes laws against libeling the State and "parasite laws, meaning open-ended laws patterned after Soviet laws which are generally criticized by Western legal authorities as arbitrary and subjective. The Government's view appears to be that the increased communication between the Government and the Church, the release of Walesa and other detainees, and the suspension of martial law represents a sign of reconciliation and a renewal of the dialogue. However, neither the Church nor Walesa characterize these developments that way. Both have called for peaceful demonstrations to attain more substantial compliance with the promise of renewal and reform.

ECONOMIC RECOVERY REQUIRES RENEWAL, REFORM, AND REINSTITUTION OF NORMAL WESTERN RELATIONS

The Three Year Plan (1983–85 inclusive) and the official Polish projections to 1990 are keyed to three forces: weather [God], reform and renewal [Pluralism] and resumed and increased commercial relations with the West. [Western, especially U.S. acceptance]. The Poles have officially identified these forces in three possible variants for economic recovery:

The first variant is based on the assumption that both in 1983–85 and the subsequent quinquennium the conditions for agricultural production will be below average, the results of economic reform will be slow to come and economic restrictions will stay in force.

---

[3] Address to Miners in "Trybuna Ludu" No. 287 Dec. 4–5, 1982.

The second variant assumes average to good conditions in agriculture, gradually rising production and economic effects of the implementation of economic reforms and the normalization of the situation in trade with capitalist countries combined with the successful negotiations of new principles of rescheduling debts.

The third variant is based on better than average crops in farming and very fast effects of the reforms, embracing in particular a significant increase in exports to capitalist countries already before 1985 and even more so thereafter. (see Table 2)

The third variant mentioned provides for a return to the pre-renewal (1980) level of output by 1985 and substantial improvement by 1990. Jaruzelski's version of "economic reform" assumes the temporary acceptance of a six-day work week and a partial return to centralized planning. According to Polish officials, the effectiveness of the institution of a six-day work week would be dependent upon popular social acceptance. Social acceptance may be tied to resumed communication between the Government, the Church and a free union movement.

TABLE 2. VARIANTS OF THE GENERAL PROPORTIONS IN 1983–85 AND 1986–90

[In 1982 prices]

	Variants—					
	1985			1990		
	I	II	III	I	II	III
Sales in industry, in billions of zlotys	7,245	7,440	7,570	8,620	9,080	9,690
1982 = 100	112	115	117	133	140	150
1980 = 100	96	99	110	114	120	129
Overall agricultural production, in comparable prices—in billions of zlotys	625	650	660	705	730	750
1982 = 100	106	110	112	119	123	127
1980 = 100	109	113	115	123	127	131
Generated national income, in billions of zlotys	4,270	4,440	4,535	5,060	5,600	5,925
1982 = 100	111	116	118	132	146	155
1980 = 100	90	93	95	106	118	124
Exports, in billion zlotys	987	1,050	1,070	1,316	1,450	1,545
1982 = 100	120	127	129	159	175	187
Imports, in billion zlotys	883	930	935	955	1,020	1,030
1982 = 100	110	116	117	119	127	128
Distributed national income, in billion zlotys	4,135	4,285	4,365	4,660	5,120	5,360
1982 = 100	109	113	115	123	135	141
1980 = 100	84	87	88	94	104	109
Overall consumption, in billion zlotys	3,240	3,390	3,470	3,750	4,075	4,260
1982 = 100	106	111	114	123	133	139

Source: ("Trybuna Ludu"), No. 193., Aug. 16, 1982.

Both the Poles and the specialists in West seem to be working under the same assumptions: the need for good weather, effective reform, and reversal of Western commercial restrictions to assure economic recovery. Whether or not General Jaruzelski fully appreciates this relationship is not clear. Many Polish officials, supporters and critics of the Government, nonetheless, do.

SOVIET ECONOMIC AND POLITICAL POLICY UNCERTAIN

The Soviet Union would like to have an economically healthy, debt-free stable regime in Poland. How much flexibility the Soviet Union would accept in exchange for economic productivity and political stability is not clear. Their acceptance of a degree of Polish Bonapartism with a weak, if not fully discredited, Polish Communist Party, indicates some flexibility, as does absention from the direct use of Soviet military power. Direct military action would be costly for the Soviets, perhaps too costly, while Polish military rule appears to be less costly and more effective.

The interaction of Soviet subsidy policy and Polish political conditions seems paradoxical. Under renewal Soviet-Polish trade provided Poland with more favorable terms of trade and a larger net transfer of resources. Meanwhile under martial law, Soviet trade with the Poles diminished as their need remained constant or grew. The blame for the poor performance of the Polish economy was shifted from the East to the West.[4]

The Soviets and some Polish leaders talk about more integration of Poland into the CMEA system. Polish economists, however, say that such a change would actually impede recovery. Little has been done to effectuate further integration.

The U.S.S.R. is not, or is not likely to become, the "debtor of last resort" for Poland or any of the CMEA countries. The U.S.S.R. is, however, very interested in the creditworthiness of the CMEA-Six for the following reasons: First, any rescheduling or default reduces the overall availability of funds on Western credit markets and increases the cost of borrowing. Second, the East European countries' ability to import and modernize is important to the Soviet Union. The CMEA-Six are a major source of imported equipment for the U.S.S.R. Without Western credit the smaller CMEA countries would have serious difficulties in importing Western products. Similarly, the Soviet Union would have an interest in keeping hard currency and energy credits available to the other CMEA members in order to reduce their vulnerability to applications of Western political conditionality that it does not approve.

Moscow, the Western capitals, and Eastern Europe have some interests in common, such as increased Polish economic growth, modernization, and enhanced consumer welfare. But, in many instances their interests are incompatible and competitive. The Soviet Union is able to, and undoubtedly does, set certain limits on change in Eastern Europe. Yet, the limits set by the Soviet Union and upheld by local Communist parties allow the region some flexibility, as Hungary's New Economic Mechanism, the GDR's technocratic professionalism, and the Polish renewal period attest. Within this range, Poland may be able to work out modified social contracts with their citizens if they choose to try. The acceptable limits of change may provide a basis for shared interests with the Western countries.

ACTIONS TAKEN BY THE WEST AND UNITED STATES—OPTIONS OPEN

Actions taken by the United States and the West as a whole fit into two general categories:

Economic restrictions.—By denial of access to Western credit markets and limiting trade with the West by removal of trade benefits (MFN, business facilitation measures), the prospects of economic stabilization and recovery in Poland have been materially restricted.

Political-social restraint.—Poland's political stability and economic recovery requires not only popular acceptance via support of credible institutions such as the Church and free trade unions but also Western acceptance by leading governments such as the United States, the Federal Republic of Germany, and the Vatican.

Reduction of both these restrictions would significantly influence Polish economic and political stability and recovery. This potential is recognized by the Polish leadership and therefore provides a basis for U.S. influence. Making the removal of restrictions and the offering of incentives contingent upon specific verifiable Polish actions could provide the reciprocal basis of a Western policy of action. What is an appropriate relationship between Western and Polish interaction is an important judgment. Determining Polish compliance in terms of rhetoric versus action is also important and difficult. But if an interactive policy is deemed fruitful, the United States might create a better opportunity for attaining or moving toward its objectives by relating incentives to Polish action.

The United States continues to be involved with the Polish government through a number of governmental and private channels. The rescheduling of the official and commercial debt is a prime example of ongoing economic engagement. Political, social, and cultural relations provide further measures of engagement. Catholic Relief and CARE serve as active bridges from the United States to the Polish economy. One might even say that the United States has already established a kind of reciprocal policy towards Poland that lacks defined priorities and options.

Discussed below are specific economic and political options open to the United States. These are considered in order of priority.

Economic options

Debt Management: Rescheduling, loan policy.
Trade Issues: MFN, joint ventures, counter trade, cooperation arrangements.
Transport, fishing and other issues: LOT flights, fishing in U.S. waters.

---

[4] Wharton Centrally Planned Economics "Current Analysis" Sept. 1, Oct. 20, Nov. 23, 1982. Andzej Olechowski, "Catastrophe and Rescue," "Polityka" No. 5, Mar. 20, 1982.

Debt management is the most significant of these issues in terms of its effect on Polish economic performance. The elimination of trade restrictions and other sanctions would not be sufficient to stimulate Variant III of the Polish economic propects, even if other variables of weather and domestic support were favorable. Debt management is the key to economic stimulation or solvency.

Debt management

As of March 1981, Poland was in default of its payments of interest and principal to Western governments and private banks. The question was then raised in banking and government circles: Should formal default be precipitated, assets seized and disposed of to meet claims? The U.S. Government took the position that formal default should not be precipitated. Western governments and private bankers concurred and proceeded to reschedule the Polish debt. Government and commercial debt rescheduling for 1981 was completed.

The U.S. Government has maintained its original position that Poland should not be forced into default. Total Polish indebtedness to the West was calculated at approximately $26 billion in early 1982. Of this total about $10 billion represents official debt, and $16 represents commercial debt. Discussions on rescheduling Poland's official debt for 1982 have been deferred as part of the U.S. reaction to the imposition of Polish martial law in December 1981. No other Western government has pursued rescheduling for 1982 either. Meanwhile, an agreement on commercial bank rescheduling for 1982 has been signed, containing provisions for rolling-over the principal, similar to those agreed for 1981, and for a trade credit facility whereby half of Poland's interest payments can be turned into short-term credits—a new innovation.

In January 1982 the Commodity Credit Corporation (CCC) was prepared to make good on its agricultural loan guarantees to U.S. banks if Poland did not meet its payments. Senator Kasten, Representative Lewis and others in the Congress were opposed to such an action and proposed legislation to precipitate formal Polish default.[5] These actions did not pass. Later when Solidarity was disbanded in October 1982, Mr. Lane Kirkland, president of the AFL-CIO, called for similar action on Polish default. Although President Reagan moved to take away Polish MFN status at that time, he again chose not to force default. This issue may be discussed further in the 98th Congress.

A number of questions need to be raised in order to determine what appropriate actions the United States should take:

1. Is Western debt repayment by Poland possible at any future time with some degree of certainty? If one accepts the Polish forecasts for 1983-85, and 1985-90, the answer is yes.

2. Can conditions of debt rescheduling and management of commercial relations with Poland be used effectively by the U.S. Government and banks to influence Polish political and economic policy? Based on U.S. banks' policy of applying economic conditions, the answer may also be yes. Further links of economic to political issues are provided by the applications of political conditionality.

If as indicated, the answer is yes to each of the preceding questions then the United States must decide whether formal default or continued rescheduling would best serve our interest. As long as some financial obligations, i.e. interest payments are met, and engagements of the United States with Poland provide leverage, then continued rescheduling might be the correct choice. If the answers are negative, the economic basis of judgment would be the reverse. The Reagan Administration action of not precipitating formal default implied that they take the positive view on these questions for the following reasons:

First, the U.S. Government would be paid something in that case and not under formal default. Some net flow of hard currency out of Poland to the United States and the West is better than none. Perspective changes in Poland's financial situation should affect the ability of the Poles to repay their debts. During the first six months of 1982, $896 million in interest was paid out of an estimated $1.4 billion due, according to the Wharton Econometric Forecasting Associates.[6] Wharton also reports considerable improvement in Poland's convertible currency trade balance with non-socialist countries, expecting a surplus of $1.5 billion for 1982. However, this suplus might have been offset by an estimated $1 billion deficit in Poland's convertible currency trade with CMEA. Poland's balance of payments, moreover, looks better for 1983. The expected decline in the world market interest rate should permit a reduction in the Polish current account deficit to non-socialist countries in 1983 to around $400 million.

---

[5] Committee on Agriculture of the U.S. Senate, "Soviet Bloc Debt and Financial Integrity of the CCC," Mar. 12, 1982.

[6] The figures in this section are taken from the Wharton Econometrics Forecasting Associates "Current Analysis," Sept. 1, Oct. 20, Nov. 23, and Dec. 23, 1982.

Second, U.S. economic influence would be retained in rescheduling and not in formal default. This policy view would incline one to argue that some influence by the use of economic conditions in rescheduling is better than no influence by the severance of commercial relations. Default is final while the terms of rescheduling payments can be manipulated.

Third, Poland's loss in access to Western markets would not involve commensurate claims on Soviet resources. Instead, this loss would surely make the Poles more dependent on Soviet assistance.

Fourth, the impact of the formal default of a large sovereign borrower such as Poland would reduce the profitability and decrease the solvency of many Western governmental and commercial financial institutions as well as cause a negative ripple effect on the entire international credit market. If the United States declared Poland in default, the banks and governments in Western Europe would automatically lose $14 billion. If other Eastern bloc countries also went into default as a reaction or for other reasons, this total would soar, reaching about $50 billion according to the Wharton group.

If the United States chooses to continue the rescheduling option, it may wish to apply its leverage more vigorously.

The following considerations would be appropriate:

(1) Use of political and economic conditionality for rescheduling terms.

(2) Establishment of preconditions for additional credits or new loans and access to U.S. programs (e.g., P.L. 480).

(3) Unified policy and shared obligations among Western governments and banks.

(4) Inclusion of U.S.S.R. in agreed rescheduling process.

These considerations would be appropriate for policy formulation as a whole but would be largely sequential in application, i.e. no new loans are likely without considerable progress in repayment, and concrete progress on revived renewal and reform.

A. Economic conditionality

The conditions pressed by U.S. banks in the Western group of commercial banks holding the Polish debt include a variety of objective requirements designed to encourage professionalism and efficiency in planning and management, to obtain more of the information necessary for assessing creditworthiness, and to encourage repayment.[7] Specifically, what the U.S. banks have proposed include the following:

1. Provision of adequate economic information.—Debtors should be required to provide economic information comparable to that generally available within and among Western countries. Conformance with the spirit as well as the letter of the guidelines contained in Basket II of the Helsinki Final Act would be a useful guide. Access to appropriate officials in the debtor country for verification and clarification of data is an essential feature of a reliable information system, i.e. the ability to understand and confirm economic information.

2. Establishment of a long-range stabilization program.—Western banks should be in a position to require the debtor country to develop a stabilization program that corrects excessive reliance on a policy of substitution of imported Western goods for presumably inferior domestic products and improves economic efficiency. The attainment of both a balance in foreign economic accounts and a balance between domestic prices and costs would be in order.

3. Tying rescheduling and new loans to information and stabilization programs.—To maximize the prospects for an effective stabilization program and for prompt repayment, the banks' agreement to reschedule old loans or provide further credit should be dependent on the debtors' willingness to supply accurate and complete information and to establish a workable long-term stabilization program. A fairly close and continuing relationship between Polish debtors and Western creditor banks and governments would enhance the likelihood of economic growth, hard currency receipts, and economic stabilization. The plan developed by the debtor country should also include a schedule for achieving specific goals. Success in meeting scheduled targets could trigger rescheduling or consideration of new loans.

---

[7] C.F. Gabriel Eichler, "Anatomie Eines Umschuldungs Prozesses" [Anatomy of A Rescheduling Process] "Nueu Zurcher Zeituny," Nov. 23, 1982.

B. Political conditionality

The establishment of new flexible social contracts in Eastern Europe might not only be conducive to improved economic performance but also to a degree of professionalism and pluralism compatible with Western values.

Tying rescheduling and loans to Polish acceptance of broader Western political goals, such as arms limitation, international crisis management, or domestic liberalization, might pose some difficulties. However, an ongoing relationship could open up many opportunities for influence and create a climate of receptivity. Specifically, General Jaruzelski could be asked to meet his own commitment to the irreversibility of renewal and the introduction of economic reforms.

Trade and other issues, such as MFN. joint ventures, air rights, fishing, etc., are secondary level issues not as significant to Polish recovery. They do, however, have symbolic meaning that transcends purely economic benefits. For example, Most-Favored-Nation treatment appears to be viewed in the broader traditional context of diplomatic relations. If Polish progress merits moving toward reopening of credit facilities, then the availability of new loans and the adoption of an appropriate new American trade strategy would be in order.

In order to hold down reductions in real consumer income and to permit necessary imports to complete priority projects, new loans—probably from Western governments—are needed. Polish Finance Minister Marian Krzak predicted in 1981 that his country's debt would jump to $33 billion by 1985-86, an increase of $6.7 billion. If there were new loans from the United States, where would they come from? The Export-Import Bank? The Commodity Credit Corporation? Public Law 480? All these vehicles are either over-committed or require new political judgment and/or legislation. New legislation would probably be a prerequisite for a U.S. loan or aid package because the commercial banks show no enthusiasm for new unguaranteed Polish loans. West European loans would be an essential precondition. Although President Reagan suggested when applying sanctions that a Marshall Plan-type approach might be possible if conditions of a return to pre-martial law were met, these incentives were not spelled out.

The Western countries might well join forces in aiding the Polish economy, with each doing what it can do best. The United States' forte might be agricultural commodities and equipment. Polish agriculture, unique among East European countries, remains largely in private hands. American assistance could contribute substantially to Poland's ability to feed itself while strengthening the private sector in that country. The Germans might provide mining equipment, the Italians automotive machinery, and the French chemicals and petrochemicals, if appropriate to the Polish plan.

During renewal at Representative Derwinski's recommendation, about 400,000 tons of American corn valued at about $55 million were to be provided to Poland before the end of August 1981, in "soft" P.L. 480 loans, to keep its chicken flocks alive. This kind of approach might be a part of contingency planning for the future. The broader Rockefeller Fund approach of the Borlaug Mission of 1982 toward aiding Polish private agriculture might be explored. CARE and Catholic aid in the interim continue to be provided through and monitored by Church channels.

POLITICAL OPTIONS

Given appropriate and verifiable compliance by the Polish government in maintaining renewal, initiating reforms and expanding pluralism, some political steps might be appropriate:

(1) Poland's current isolation from the West might be ended. Western and U.S. ties if reestablished provide a degree of ligitimacy not attainable from other sources.

(2) A visit of the Pope and "normalized" relations, i.e. a resumed dialogue between the Polish Government and the Catholic Church at home and abroad, would provide considerable legitimacy.

(3) Resumed ties with the West could give the Poles "room to maneuver" in their dealings with the U.S.S.R.; and Poland may be encouraged to use and expand its sovereign rights in developing a more pluralistic and humane society.

The Polish issue as a source of Western unity or division

It may be that limited Polish actions could lead to West European judgment that Poland has met the economic and political requirements necessary for reacceptance into the Western market, while the United States, in contrast, might see anything less than extensive changes over a prolonged period as cosmetic or worse. If this were to become the case, the Polish issue might take on some of the divisive characteristics of the "pipeline" issue, splitting the West as a whole and corroding Western unity.

By the beginning of 1983, the Jaruzelski government has claimed compliance with their promises of December 13, 1981—renewal is irreversible and reform is under way. This may be the occasion the West European countries have been looking for to resume "normal" relations with Poland based on the following:

(1) *Acceptance of political conditions of reform and renewal.*—A continuation of reform and basic dedication to renewal (obnowa) is related to the Sejm's passage of further reform decrees covering foreign joint ventures, anti-monopoly, regulations and an expanded independent role for the Sejm. Earlier decrees, including those on self-management and price reform, are said to be still in force although not yet effective. The Sejm is futher empowered to debate and vote on budgetary measures and audit compliance with legislation. A new constitutional amendment is being discussed to ensure private agricultural rights, including ownership and inheritance. A new joint venture law that would provide for foreign equity ownership and participation is scheduled for discussion. A law permitting full foreign ownership in small industry is in effect creating the "Polonia" enterprises. These may provide vehicles for new European direct investment in Poland.

(2) *Acceptance of free trade union movement.*—The charter of the new "free" trade unions was passed and submitted to the International Labor Organization (ILO). The ILO had reservations on the "freedom of assocation" and called for further changes. The United States agreed with the ILO. The Poles may be able to implement the ILO changes, promptly raising the question of West European acceptance of a Polish "free" trade union organization.

(3) *Acceptance of debt management plan.*—The 1982 Western commercial debt rescheduling has been agreed to by Poland and Western lenders. Government rescheduling has not begun for 1982. The West European governments might proceed with or without the United States. Chancellor Kreisky of Austria has informally proposed a Western financial aid program for Poland, which he may present to President Reagan in his upcoming visit in early 1983. This program would involve substantial new loans. A fall in the interest rate may provide a basis for reducing the debt servicing, increasing the hard currency available to Poland from Western purchases without new loans.[8]

(4) A reconvening of the United States-Polish Joint Economic Committee might, if political improvements permit, be the forum for working out a reciprocal program of sanction removal/economic benefit that is keyed to Polish actions regarding renewal and reform. The U.S.-Polish Chamber of Commerce might be a nongovernmental channel for communication. This set-up, in turn, might provide the basis for a useful Western policy action through EEC, OECD, or other intergovernmental bodies.

CHRONOLOGY OF MAJOR EVENTS UNDER POLISH MARTIAL LAW

December 13, 1981.—General Wojciech Jaruzelski proclaims martial law and rule by 21-man military council of national salvation (mcns) promises continuation of post-August 1980 reforms and "preservation of the basic features of socialist renewal."

Martial law decree "suspends" basic civil rights and independent Solidarity trade union (bans strikes, independent political activity, public gatherings, demonstrations, domestic and foreign travel, and dissemination of all publications and information), introduces curfew, closes down all communications, and interns or arrests solidarity activities, advisers, dissidents, and others whose loyalty to the military regime is suspect.

December 14, 1981.—Sit-in strikes begin at Piast and Ziemowit mines near Katowice. Poland misses deadline for rescheduling $2.4 billion in principal due 1981. Interest arrears estimated at 350 million dollars.

December 15, 1981.—Military men begin to replace civilian governors in cities such as Elblag, Katowice and Radom. Many senior industrial managers dismissed for "inability to adapt to the requirements of the martial law emergency."

December 16, 1981.—Radio Warsaw reports that security forces killed 7 miners and injured 39 in clashes at the striking Wujek colliery near Katowice Dec. 15.

---

[8] Wharton, "Current Analysis," Dec. 23, 1982. p. 13. The expected decline in world market interest rates should permit a reduction in Poland's current account deficit from an averge of $2.9 billion in 1977-81 and $1.9 billion in 1982 to around $400 million in 1983.

Reports from Gdansk that 164 civilians and 160 and militiamen injured in street demonstrations marking anniversary of 1970 events.

December 19, 1981.—Strikes continue in Katowice steel mill. Farmers are warned of possible compulsory food deliveries.

Saying "Poland is under a reign of terror," Polish Ambassador to the U.S. Romuald Spasowski requests and receives political asylum.

December 23, 1981.—Security forces break strikes in Katowice steel mill and Zieowit coal mine.

President Reagan announces that the U.S. would continue to ship food to Poland through private humanitarian channels if assured it would reach the Polish people.

In response to the declaration of martial law, Reagan announces sanctions against the Polish military junta; he suspends all U.S. Government-sponsored agricultural and dairy shipments to the Warsaw authorities, halts renewal of Poland's line of export credit with the U.S. Import-Export Bank, suspends Polish civil aviation privileges in the U.S. and Polish fishing rights in U.S. waters, and proposes that Americans allies should further restrict high-technology exports to Poland.

December 24, 1981.—Zdzislaw Rurarz, Poland's Ambassador to Japan, asks for political asylum in the U.S.

December 27, 1981.—The military regime announces reductions in meat and butter rations for all except manual workers and children under 18.

December 28, 1981.—Strike at Piast mine ends. Despite promises of immunity, the regime arrests 12 miners and strike leaders. Poland begins to jam Voice of America broadcasts.

December 29, 1981.—President Reagan announces a series of U.S. economic sanctions against the Soviet Union for its part in the imposition of martial law in Poland.

Regime spokesmen say 580 of 5,050 people interned in "isolation centers" have been released.

December 30, 1981.—Polish State Council postpones local elections due in February. New decree makes work compulsory for all men between 18 and 45 for duration of martial law.

January 2, 1982.—Substantial price increases for coal, electricity and food. The Polish zloty is devalued against major Western currencies.

January 4, 1982.—Lenin and Warski shipyards in Gdansk and Szczecin resume work. According to uncensored reports, continued purges of Solidarity supporters have halved Lenin shipyard work force.

Foreign ministers of European Community issue communique in Brussels criticizing developments in Poland.

January 5, 1982.—Poland's independent students union is dissolved on grounds that its activities are incompatible with public order.

January 6, 1982.—U.S.S.R. grants Warsaw long-term credits to cover Poland's trade deficit with Soviet Union and finance import of Soviet goods. In Epiphany sermon, Poland's Primate Archbishop Jozef Glemp critizes prolonged internments, arrests and dismissal from jobs of those who refuse to sign pledges of loyalty to military regime.

January 9, 1982.—Deputy Prime Minister Janusz Obodowski says Poland's foreign debt is $28.5 million and country needs at least $1.5 million in new credits every quarter.

Government press spokesman says 1,433 people arrested for martial law violations. Legal proceedings begun in 916 cases and 276 persons already sentenced.

January 10, 1982.—Poland lifts censorship of foreign correspondents, restores telephone services in, but not between, cities. Censorship and interruption of telephone conservations continue.

January 11, 1982.—Special NATO ministerial session condemns imposition of martial law in Poland and denounces the massive violation of human rights in Poland and denounces the massive violation of human rights and the supression of fundamental civil liberties in contravention of the U.N. Charter, the Universal Declaration on Human Rights, and the Helsinki Final Act.

NATO governments decide to withhold further commercial credits to Poland, except those for food, and to suspend talks on the rescheduling of Poland's debts.

January 14, 1982.—First issue of pro-regime daily Rzeczpospolita appears.

January 16, 1982.—The New York Times publishes interview with Zbigniew Bujak, a fugitive Solidarity official. He says the labor union has gone underground and will peacefully resist the military dictatorship.

Polish communist party newspaper Trybuna Ludu warns farmers that continued withholding of grain from the state might result in the introduction of compulsory deliveries.

January 17, 1982.—Archbishop Glemp says new arrests are being made under martial law and again criticizes extraction of loyalty oaths by regime. Deputy Chairman of the Party Central Control Commission says about 1,000 people were expelled from the Communist Party in first three weeks of martial law, and another 1,300 struck off membership list.

January 18, 1982.—Polish army daily Zolnierz Wolnosci demands continuing purge of Communist Party so that a strong, united and ideologically hardened party would emerge after the lifting of martial law.

January 21, 1982.—According to Polish Ministry of Justice, more than 150 Solidarity activists imprisoned for organizing strikes and protests since declaration of martial law of 152 people sentenced between December 13 and January 15, 30 were imprisoned for more than three years. The European Common Market withdraws proposal to supply more than $236 million in food aid to Polish government.

January 22, 1982.—Ministry of Internal Affairs says several hundred people fined or sentenced to prison every day for breaking curfew regulations.

January 24, 1982.—Pastoral letter from Polish episcopate calls for restoration of freedoms revoked under martial law.

Polish primate warns in radio broadcast that curbs on freedom could lead to protests and war.

January 25, 1982.—Polish Sejm (parliament) endorses martial law.

January 26, 1982.—In speech to Sejm, Jaruzelski says there are 4,549 internees and that 1,760 people have been released.

January 30, 1982.—Riot police disperse thousands of demonstrators in Gdansk and arrest 205 people. The 8:00 pm curfew is reinstated, private telephones disconnected and use of private cars banned.

February 1, 1982.—Consumer prices rise by up to 400 percent.

February 3, 1982.—Twelve senior Solidarity leaders still at liberty reportedly agree to head a national commission of resistance to martial law. Poland announces that about 760 officials have been ousted since the imposition of martial law, including 6 provincial governors, 14 deputy governors and 160 mayors.

February 8, 1982.—Polish universities resume normal classes for first time since December 13.

February 9, 1982.—Pope John Paul II says restoration of rights to Soldiarity is the only solution to Poland's crisis.

February 11, 1982.—First issue of Mazowsze Weekly joins the more than one thousand underground publications which have appeared since December 13.

February 13, 1982.—Polish authorities arrest 194 people and impose strict controls on travel, communications and assembly after security forces quell demonstration by 6,000 people in Poznan to mark two months martial law.

February 14, 1982.—In "operation calm", Polish security forces detain, arrest, fine and warn over 145,000 people for violating martial law decrees.

February 17, 1982.—Poland announces sharp drop in industrial, agricultural and trade output for January.

Compared with same period in 1981, exports dropped 18.5 percent and imports 17.3 percent.

Coal production rose 5.1 percent over January 1981.

February 24, 1982.—Polish press attacks Solidarity leader Lech Walesa as a figurehead for an anti-communist crusade.

February 25, 1982.—Two-day session of Central Committee of Polish Communist Party endorses martial law.

February 26, 1982.—Polish episcopate issues statement calling for lifting of martial law as soon as possible, resumption of a genuine dialogue between regime and society and an amnesty for Solidarity leaders in internment or hiding.

February 27, 1982.—In second plenary session under martial law, Sejm approves two ministerial changes, passes a series of draft bills dealing with economic matters and praises the restoration of order.

March 2, 1982.—Jaruzelski returns to Poland after two days in Moscow with promises of economic aid and qualified Soviet endorsement of his position vis-a-vis polish hardliners.

March 3, 1982.—Polish Ministry of the Interior announces that internees and their families would be allowed to apply for passports to emigerate—only a handful do so.

March 8, 1982.—The Minister of Justice says that 3,953 persons are still interned and that some internees held since December 13 will be put on trial—despite an amnesty for activities before that date. He confirms that Walesa is an internee detained without charges. The Chairman of Solidarity's Podbeskidzie region is sentenced to six years for not ceasing union activities.

March 10, 1982.--The U.N. Commission on Human Rights condemns Poland for human rights violations and directs the U.N. Secretary General to investigate continued violations of international agreements signed by the Polish Government.

March 12, 1982.—The Madrid review meeting of the Conference on Security and Cooperation in Europe recesses until November following a month of East-West polemics over the imposition of martial law in Poland.

Members of the European Community agree to cut Soviets imports to protests martial law in Poland.

March 13, 1982.—Polish industrial production fell sharply in February compared with same month in 1981.

March 16, 1982.—Poland's army newspaper claims that new information shows that Solidarity was infiltrated by spies.

March 19, 1982.—The Polish Journalists' Association is dissolved because it undertook actions conducive to the dismantling of state and social institutions of public information.

March 20, 1982.—Polish regime launches the Association of Journalists of the Polish People's Republic.

These actions follow a campaign of ideological verification, which resulted in the dismissal and resignation of thousands of journalists.

March 24, 1982.—Poland's Military Prosecutor's Office says that 44 percent of civilians arrested were suspected of anti-state crimes, 17 percent of illegal possession of firearms, 9 percent of infractions of military discipline imposed in major factories and mines, and 7 percent of illegal attempts to cross Polish borders.

March 31, 1982.—Warsaw daily Express Wieczorny says Poland received 46,000 tons of Western aid in January-February, compared with 50,000 tons for 1981.

April.—Polish press continues to attack Solidarity in what the military regime calls a public discussion on the future of trade unions.

April 6, 1982.—Western banks and Polish officials sign agreement to reschedule $2.4 billion in debts that Poland should have repaid in 1981.

April 8, 1982.—Warsaw University Rector Henryk Samsonowicz—democratically elected in August 1981—is forced to resign following conflicts with military regime over increased party control of universities, compliance with the new university regulations under martial law, and ideological verification of faculty members. Six other university rectors have been dismissed or forced to resign.

April 11, 1982.—In Easter sermon, Archbishop Glemp outlines proposals for a social accord drawn up by the Council of Biships—proposals include release of internees, the reactivation of Solidarity and the renewal of a genuine dialogue between the regime, Church and suspended independent trade union.

April 12, 1982.—The clandestine station Radio Solidarity broadcasts for first time.

April 15, 1982.—Protests at Warsaw University over resignation of Rector Samsonowicz.

April 16, 1982.—Two principal shipyards and municipal transportation go on strike in Gdansk.

April 21, 1982.—The Polish United Workers Party (communist) announces the expulsion of 44,500 members in March.

April 22, 1982.—Four Solidarity leaders who escaped arrest form a temporary coordinating commission for Solidarity under martial law, issue call for 15-minute general strike on May 13 and urge Solidarity members to rebuild union network underground.

April 23, 1982.—At Eighth Plenum of Central Committee of Polish Communist Party, Jaruzelski warns Poles that there will be no significant improvement in standard of living before 1990.

April 28, 1982.—On instructions of ruling junta, the Ministry of Internal Affairs announces that 800 internees will be released May 2, and 200 others will be granted leave conditional on good behavior.

May 1, 1982.—Large peaceful demonstrations protesting martial law take place over a dozen cities.

May 2, 1982.--Curfew lifted and other martial law restrictions eased.

May 3, 1982.—Street rioting in Warsaw, Gdansk and other Polish cities on anniversary of 1791 Constitution.

The military regime reimposes curfew, cuts telephone and telex communications and restricts travel.

Street demonstrations continue for several days and are violently dispersed by riot police.

May 4, 1982.—The Minister of Internal Affairs announces that 1,372 people were arrested after disturbances on May 1 and 3.

May 10, 1982.—Polish authorities say 2,269 people arrested in disturbances since May 1. 211 were interned and 1,339 were sentenced to up to three months in prison or fined. Fines for certain offenses have been raised and some quadrupled.

May 13, 1982.—Undetermined number of Polish workers participate in 15-minute general strikes and other forms of resistance to protest five months of martial law. Demonstrations also take place at Universities.

May 17, 1982.—CPSU Central Committee Secretary Rusakov and Warsaw Pact Commander-in-Chief Kulikov begin friendly working visits to Poland.

May 18, 1982.—International Labor Organization special envoy Nicolas Valticos ends five-day fact-finding visit to Poland. Talks with regime officials and Lech Walesa.

May 26, 1982.—Deputy Premier Madej tells Sejm that Western imports have fallen by 43 percent in the first quarter of 1982 over the corresponding period of 1981. Says that Poland has choice of meeting food needs or importing essential raw materials. Warsaw's evening daily says half of Poland's construction firms face bankruptcy.

May 27, 1982.—Lech Walesa is transferred from place of internment outside Warsaw to a location near Poland's eastern border with the U.S.S.R.

May 28, 1982.—President Reagan approves for fiscal year 1983 a $68.7 million food and medical aid package for Poland to be sent through private voluntary agencies.

June 3, 1982.—Katowice military court passes sentences of up to four years imprisonment on four people accused of not ceasing trade union activity and distributing leaflets.

June 4, 1982.—Jaruzelski visits Romania and rounds out his tour of Warsaw Pact capitals begun in March.

June 5, 1982.—Hardliner Stanislaw Kociolek—Warsaw Provincial Party Secretary and critic of Jaruzelski policy—is named Polish ambassador to Moscow.

June 10, 1982.—Communique issued by Council for Mutual Economic Assistance meeting in Budapest says that member states are assisting the fraternal Polish people to enable them to surmount their economic difficulties and further develop socialism.

June 11, 1982.—At trial of Solidarity leaders charged with organizing a strike at the Lenin shipyard in Gdansk, Jan Waszkiewicz is acquitted and committed to a mental institution. Others receive sentences of one to four years.

Unofficial Polish sources say that 30,000 people have been sentenced since the declaration of martial law.

June 13, 1982.—Security police crush demonstrations protesting six months of martial law in Wroclaw, Nowa Huta, Gdansk and other cities. On subject of planned papal visit to Poland, Official communique says that adequate conditions, which depend on the progress of normalization, are essential before the Pope will be allowed to return to his homeland.

Communist Party Secretary Mokrzyszczak says that 2,488,000 people are Party members and that the Party has lost 660,000 members since July 1980.

June 14, 1982.—East European delegates walk out of annual conference of the International Labor Organization when a Polish journalist, waving an authorization signed by Walesa, addresses the session.

June 18, 1982.—A TASS article opposes planned papal visit to Poland and accuses the Polish church of trying to assume the role of a political opposition vacated by the suspended Solidarity trade union.

June 22, 1982.—Minister of Higher Education announces that a process of ideological verification will be instituted to purge unfit faculty and deans at universities.

June 23, 1982.—Soviet weekly Literaturnaya Gazeta attacks Polish church for alleged involvement in political activities and accuses clergy of complicity in June 13 disturbances.

June 26, 1982.—Thousands demonstrate in Radom and Ursus to mark the anniversary of clashes between workers and police in 1976. Tygodnik Mazowsze publishes a Solidarity call for a moratorium on all protests until July 31.

June 28, 1982.—Peaceful demonstrations in Poznan, commemorating the deaths of at least 75 workers in the 1956 protests, are dispersed by tear gas and water cannons.

June 29, 1982.—After weeks of silence on the subject of the Solidarity trade union, the Polish party daily Trybuna Ludu says that Solidarity should not be revived in any form lest it become a legal cover for the anti-socialist underground union.

October 8, 1982.—The independent trade union Solidarity is officially banned by a law passed in the Sejm.

October 9, 1982.—In response to the outlawing of Solidarity, President Reagan removes Poland's Most-Favored-Nation status.

November 3, 1983.—An agreement on rescheduling Poland's 1982 commercial debt is signed. It contains both a rescheduling agreement on the principal due and a trade credit facility.

November 8, 1982.—General Jaruzelski announces that Pope John Paul II would visit Poland in June 1983.

November 13, 1982.—Solidarity Leader Lech Walesa is released after 11 months of detention.

December 16, 1982.—Lech Walesa is detained by Polish authorities in order to prevent him from making a speech in Gdansk to commerate the 1970 worker protests.

December 19, 1982.—Poland's collective presidency, the Council of State, announces that martial law will be "suspended" on December 31, 1982.

December 29, 1982.—TASS distributed a sharp attack on Pope John Paul II asserting that under his leadership the Vatican was involved in "subversive" activities in Poland as well as in "anti communist" propoganda on a large scale.

NATIONAL ASSOCIATION OF MANUFACTURERS,
Washington, D.C., February 24, 1983.

Hon. CHARLES McC. MATHIAS, Jr.,
U.S. Senate,
Washington, D.C.

DEAR SENATOR MATHIAS: The decision made by your Subcommittee to hold hearings on International Financial Issues, in particular on the proposed increase in the International Monetary Fund (IMF) quota, was welcomed by us, at the National Association of Manufacturers. The issue of global debt has come to the fore at a time of great economic and financial strain. We are confronted with a prolonged worldwide recession, characterized by growing unemployment, spreading protectionism, several devaluations, sharp declines in commodity prices and a contraction in the volume of world trade.

The present global economic environment has seriously strained the debt servicing capacities of the developing countries, especially those in Latin America. The manner in which the international community responds—either with inward looking and excessively nationalistic policies or with cooperation and coordination—will ultimately determine whether the present situation deteriorates or improves. This, in turn, will have direct bearing on the chances for a sustained economic recovery in the United States. All members of the international community have a responsibility to play an appropriate role in assisting world economic recovery. One way in which the United States can carry out its role in overcoming present difficulties is by helping to increase the IMF quota by 47.4 percent from its current $66.8 billion to $98.5 billion. This would entail increasing the present U.S. membership quota of $13.7 billion by $5.8 billion.

The importance and necessity of increasing the IMF quotas, from the standpoint of the world economies as well as the U.S. economy, can best be understood in the context of increased world economic interdependence. The integration of the world economy was greatly accelerated in the 1970's by the rapid escalation in oil prices and the rise in the LDC debt occasioned by oil price increases. Despite the high levels of growth achieved by some developing countries during this time, the non-oil developing countries have faced adverse external environments for nearly a decade. They have experienced recurring recession or slow growth, poorer export earnings in world markets, declining terms of grade, high nominal and real interest rates and rapidly rising energy costs. For those countries which, nonetheless, sought to maintain industrialization and economic development, it was necessary to borrow abroad. Many of them did, on an unprecedented level, which left many of the non-oil developing countries with an enormous debt. From 1973 to 1982 the quantities of debt of these countries increased from about $100 billion to about $500 billion. As the global recession continues, some of the borrowers may be pushed to the edge of default.

Since the United States is the hub of the integrated world economy, it is only natural that U.S. banking and trading facilities have played a role in recent developments. Currently, however, U.S. commercial and governmental institutions alone are not sufficient to safeguard U.S. interests in the world economy. Under the present circumstances of a world economy under strain, it is appropriate that international institutions, such as the IMF, assume a larger role in easing that economic strain.

A brief glance at some of the U.S. interests in the world economy which would be aided by constructive action by the IMF indicates the validity of strengthening the Fund.

The risks developing from the payments problems of the LDCs do not just involve those countries on the verge of default and the lenders who face large loan losses. The interrelatedness of world markets spreads the impact of those problems to our economy and to the economies of the rest of the industrialized world. The most harmful effect of the current debt and liquidity problem is the possible worsening of the current economic contraction. Developing countries which are facing liquidity problems do not have the means to import. As individual nations restrict their economic activity, the world economy becomes static. In the United States, for example, much of the growth in trade in the past decade reflects an increase in exports and imports with developing countries.

Trade with Latin America is especially important to the United States. Thus we are particularly affected by the serious debt problem in our own hemisphere. Brazil and Mexico, in particular, have been very heavy borrowers. A look at our bilateral trade balance with Mexico illustrates the serious effects such a debt problem can have on the U.S. economy. In 1980 the United States had a manufactured trade surplus with Mexico of $7 billion. This surplus increased to $10 billion in 1981 as Mexico's oil revenues allowed it to purchase more from the United States. In 1982, however, the trade surplus dropped to $5 billion due, in major part, to Mexico's debt servicing problems which necessarily curtailed the purchase of many imports from the United States. Such a drop in U.S. exports has a serious dampening effect on the U.S. economy, an effect which we can ill-afford to ignore. It has been predicted by the Administration that because of the developing countries' debt problems, this year's U.S. trade deficit will be $10 billion to $20 billion larger than in 1982. This translates into a loss of about 0.5 percent in U.S. GNP.

As illustrated above, exports to developing countries are, and will continue to be, a crucial element in the recovery of the U.S. economy. However, the competitiveness of those exports in developing country markets depends largely on the financing which buyers of those goods can receive. Taking into consideration the importance of competitive financing, it is our view that adding punitive and overly restrictive requirements on U.S. banks lending in those countries would be counter productive. Such unduly restricted lending policies would result in higher interest rates which would, in turn, make U.S. goods less competitive in the affected markets and would, furthermore, increase the already heavy debt service burden on developing countries.

Private banks alone, however, cannot deal sufficiently with the debt difficulties in developing countries. The IMF, on the other hand, is one of the few existing institutions that can accommodate the adjustment process of countries such as Mexico. Conditionality can insure that credit is allocated properly, and it can promote a strengthening of the world economy. In Mexico, for example, the conditions of an IMF loan require that in one year the Mexican Government reduce a deficit that currently equals 16 percent of gross domestic product to a deficit of 8 percent. Such an effort requires a major reversal of Mexican fiscal policies, and this could materially help to salvage and ultimately to restore the Mexican economy to good health.

The IMF is helping to meet the needs of Mexico and of Brazil, and is struggling to aid developing countries around the world. Unfortunately, current IMF resources are not equal to meeting the credit needs of the LDCs. It has committed most of its $65.9 billion fund, and it is expected to face a shortfall by next year. The IMF quota has simply failed to keep pace with a growing demand on its resources. In the past decade alone, world trade has increased six fold, in terms of dollars, far outpacing the growth in IMF funding. As a result the 47.4 percent increase requested for this year is, in effect, a modest and very reasonable request.

Furthermore, the increase in the U.S. contribution to the IMF quota does not entail a direct call on the U.S. budget. Under U.S. budgetary and accounting procedures, the increase is treated as a "transfer of assets" rather than an "outlay" and so will not increase the Federal budget deficit.

In addition, the U.S. contribution to the IMF quota is only a standby commitment. It involves cash advances only when and if demands on the IMF exceed the amounts that can be provided from current resources. Should the IMF call upon the U.S. commitment, there is an equal and offsetting debit and credit to the appropriation account, as the cash transferred to the IMF is reflected in an increased U.S. reserve position in the Fund. That reserve position is freely available to the United States in time of foreign exchange need.

In light of the important role the IMF could play in alleviating the strains on the world economy, warding off the difficulties which could be caused by developing countries' debt repudiation seems to be a prudent step. Considering the stake the United States has in improved prospects for the world economy and particularly the needs of Latin America, I urge you to support the proposal for increasing the IMF quota. The results will be beneficial to the U.S. economy, and the costs, budgetary and otherwise, will be very small.

I would greatly appreciate it if you could make this letter a part of the record of the Committee's hearings.

Sincerely,

Lawrence A. Fox,
Vice President and Manager,
International Economic Affairs Department.